S. HRG. 101-973, VOL. II

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

REFORMING FEDERAL DEPOSIT INSURANCE, MODERNIZING THE REGULATION OF FINANCIAL SERVICES, AND MAINTAINING THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL INSTITUTIONS

VOLUME II OF III

MAY 3, 17, 22, JUNE 13, AND 20, 1990

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DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

VOLUME II OF III

THURSDAY, MAY 3, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dixon, Shelby, Graham, Wirth, Garn, Heinz, and Mack.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all in attendance this morning and most especially a very distinguished witness, Gerald Corrigan, who is with us today.

Since the beginning of April, this committee has been considering the related issues of financial modernization, deposit insurance reform, and the international competitiveness of American financial institutions.

During the first four hearings, we heard from a variety of industry trade associations and consumer groups. Today's hearing departs somewhat from its predecessors in this series.

This morning we will have only one witness and that is Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York. Clearly, Mr. Corrigan is one of this country's foremost experts on financial services and he has figured prominently in the financial modernization debate for several years and has been a leader in that discussion. We are very pleased to have you with us today.

When we invited Mr. Corrigan to testify, we asked him to address three questions. First, how should the current system of Federal deposit insurance be changed or reformed; second, what should be done to improve the current regulatory structure; and finally, what new powers, if any, should be granted to banks or their affiliates. If new powers are to be granted, when should they take effect and what protections that would be needed to safeguard the deposit insurance fund?

In response to this request, Mr. Corrigan has provided the committee with a complete and very thoughtful testimonial response which includes several appendices. I am confident it will have great value to the committee down the road.

It obviously represents a very considerable effort on his part and his staff's part. We are genuinely grateful for that work and we will use it as we prepare this year ourselves, to lay the foundation for what we anticipate will be a major legislation early next year.

Mr. Corrigan's written testimony makes some insightful comparisons between the banking systems of this country and other leading industrialized nations. It advocates the adoption of a financial services holding company model that would permit banks to enter the securities business and securities firms to enter the banking business, through separate affiliates.

In addition, it vigorously advocates regulatory reforms to facilitate the consolidated supervision of financial services holding companies. We will examine a number of these issues this morning. We are delighted to have you with us.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Mr. Corrigan, it's nice to have you with us again. You have been before the committee many times over the years and have always made very valuable contributions. Maybe one of the reasons that I am pleased you are here again is because I generally agree with you and it's nice to have friendly witnesses, but you are certainly a very noted scholar in the financial system.

I share your concerns about the international standing of our financial institutions, the changes that are occurring in the international capital markets, and I certainly agree that we have got to create a structure that is more in step with the realities of the marketplace.

I also gather from your prepared testimony that you do not view deregulation of our financial services industry as increasing risks, but rather as a necessary ingredient in reforming our system.

So I welcome you again and look forward to your testimony today.

The CHAIRMAN. Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Corrigan, we are very pleased to have you here and value your input. As you know, Senator Graham and I have introduced essentially the legislation that you proposed on a financial services commission to look at a lot of the underlying issues you are going to be talking about today and also to look at reforms in the electronic payment system which I think are long overdue which you have been a strong advocate of and which always seem to get the last bit of attention if they get any attention at all.

So we are trying to push forward a lot of the things on your agenda which I think are very important.

Obviously, the jurisdiction of regulatory issue remains right at the front of all of these questions and we value your counsel and the very complete job you did for us. Again, we appreciate your help.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I join you and Senator Garn in welcoming Mr. Corrigan back to this committee.

As I read his testimony, I want to commend him on his consistent and strong support of the Corrigan proposal made some 3 years ago. As he does point out in his testimony, one of the major components of our financial system is the safety net, deposit insurance, access to the Fed window and the payments system and, of course, that safety net is intended to provide integrity and stability to our Nation's financial system.

But as we all have learned in this committee above all, the financial collapse of a large segment of the thrift industry tore a huge hole in the safety net and while it works to provide the savings of millions of depositors, it failed to protect the wallets of the taxpayers.

So, Mr. Chairman, I think you're right, we will some time next year undertake financial restructuring once again, but in doing so I think we have to repair the financial safety net in a way where it doesn't trap the taxpayers and, from this Senator's view, while it is certainly important to enhance the competitiveness of the U.S. financial services industry as a high priority, it is this Senator's view that the American taxpayer has to be protected from failures of financial firms and that that should come first.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. I, too, want to welcome you, Mr. Corrigan. We have over the years have had an opportunity to chat from time-to-time on some matters impacting the financial concerns of our country and I have come to value your advice and I'm just here today to listen to your testimony. I look forward to it.

Thank you.

The CHAIRMAN. Mr. Corrigan, we are going to make your full statement a part of the record and we would like you to give us your summary comments. There is no need for you to feel pressed for time. You are the only witness today.

STATEMENT OF E. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. CORRIGAN. Thank you, Mr. Chairman, and as you have suggested already, I would anticipate that this entire statement would be submitted for the record. I, in one sense, apologize for its length but, in another sense, I think its length is symptomatic of how enormously complex these issues really are, especially when we look at them as we must in a global context.

I feel very strongly, as you know, that the reform and modernization of our banking and financial system as a whole must be a high national priority. I think it deserves that level of attention, in part for competitive reasons but also, and perhaps more importantly, because the smooth, safe functioning of our financial institutions and our financial markets is an indispensable and crucial element to the smooth functioning of our economy as a whole, as well as the preservation of the leadership position of the United States in the financial markets and institutions.

Indeed, I would submit to you that at the extreme the issues here even bear ultimately on the role of the United States' dollar as the world's reserve currency.

I have said on many occasions in the past that banks are special, but I should have added—and I will add now—that investment banks are special, too, as are insurance companies, because what's really special is the fabric of the financial system as a whole and that is what I have tried to address in my statement.

I am mindful, Mr. Chairman, that to some the work of the Banking Committee may seem in some ways secondary to the work of the Finance Committee or the Foreign Relations Committee or the Budget Committee. I don't really see it that way because if we fail to come to grips in this committee and the Congress as a whole with the issues discussed in my testimony, it seems to me inescapable that it will make the challenges facing those committees even that much more difficult to deal with over time.

My statement as a whole is designed, if nothing else, to provide the committee with a very broad framework, with a great deal of emphasis, as you suggested, on the international side. It really doesn't lend itself too readily to a summary, but let me just touch on a few of the highlights.

The first section deals with a comparison, if you will, of the key structural elements of banking systems in the major industrial countries. It concludes, among other things, that the U.S. system as it exists today is simply out of step with realities in the rest of the world and perhaps more importantly it is out of step with the realities in the marketplace. And with developments such as the second banking directive and related matters in Europe coming upon us with the speed with which they are, the situation is only going to get worse if we do nothing here.

The second part of that international comparison deals in some detail with what I call safety net arrangements abroad. Part of that is descriptive. The descriptive part indicates, among other things, that the principle of consolidated supervision, which as you know is rather near and dear to my heart, is universally practiced in all of the major foreign countries studied. It is also interesting that as a general matter the things we call firewalls—which I carefully distinguish in my statement from so-called Chinese walls—that would rigorously or legally prohibit the movement of capital or liquidity among affiliated companies in an overall group are not generally found abroad.

It also suggests, again pretty much without exception, that major financial firms of all kinds in all the foreign countries studied have access to the account, payment and liquidity facilities of their respective central banks.

Finally, it suggests that as in the United States all of the countries studied have deposit insurance systems. Those deposit insurance systems have some similarities and some differences with those in the United States. The most important similarity is that all have some kind of a formal or statutory limit on the amount of deposits that are insured. The most important difference is in the foreign countries studied the private sector has a larger role in the operation and administration of deposit insurance funds than is the case in the United States.

One of the most interesting—at least in my mind's eye—part of the testimony deals with a series of case studies having to do with the de facto operation of the safety net in foreign countries and there is an appendix, one of six, that looks into this particular question in some detail. That analysis in its own right I think leads to some interesting conclusions; the first being, with the exception of the well-known Herstatt case in Germany in 1974, the authorities in all of the countries studied simply have not and do not permit disorderly failures of important banking or financial institutions. And for these purposes, "important" clearly does not mean or is not restricted to "large." Indeed, it seems to me based on these studies as well as my own ongoing contacts with officials abroad that the lasting legacy of the Herstatt case has had a profoundly important influence on the thinking of authorities in all countries.

Second, the work suggests that in de facto terms again the authorities in all of the countries studied go to considerable length to protect all depositors, large and small, insured or uninsured, in the practical day-to-day world in which these systems operate.

Third, it suggests that strong elements of protection have been extended not only to banks but to more nonbank financial institutions alike, and here, too, "important" does not mean "large."

Quite clearly, this work suggests that the fundamental reasons why this is the practice that concerns of a systemic risk nature seem to loom just as large in the minds of the authorities abroad as they do the authorities in this country.

Finally, the work also suggests that on balance—and I do want to emphasize the "on balance"—on balance, private institutions, particularly large banks, probably play a more direct and larger role in rescue efforts, if I could use that term, in foreign countries than has been the case in this country, although obviously I point to a number of examples in this country where the same pattern has been true.

It raises an important question, in my mind anyway, as to why that is so. Why is it that private institutions, again on balance, seem to work more directly with the authorities in these rescue efforts abroad than they do in this country, whether it's "voluntary" or not?

I can't really answer that question, but my own observations suggest to me that it's partly true for historical reasons—that's the way it's always been done—but it is also true, I think, because in every one of these other countries there are relatively few, if not a very small number of, large banking institutions that make up the critical mass of the system. It may simply be that, where there is a handful of large institutions, they feel more vulnerable to these systemic concerns than may be the case in this country where we have such a diverse banking system.

It's probably also true as a practical matter that, where you have, again, a relatively small number of institutions that make up the critical mass of the system, it's a bit easier for the authorities to get them together and hammer out workable approaches. I suggest in that regard that it is not entirely an exaggeration that one of the most potent weapons available to the Bank of England in these matters is the governor's eyebrow.

On balance, however, what that analysis points to is that in de facto terms the operation of the safety net in foreign industrial countries is in fact quite similar to the experience in this country and, if anything—I again emphasize—if anything, the authorities abroad may go further than the authorities typically go in this country to engineer rescue efforts in the face of problems in the financial sector or with financial institutions. That's another way of saying that, if anything, U.S. institutions may be subject to a greater degree of market discipline than would be the case in other countries.

But yet, as I take inventory, what I see is a situation in which, on balance, we've had more financial disruptions—to use the nice term—in this country than has been the case certainly in any other individual country but maybe even relatively to the other industrial countries as a roup.

That, of course, raises the question why? Why, if the safety net operates the same way or, if anything, is more generous abroad, do we have this experience in this country?

Now before trying to answer that question, Mr. Chairman, we have also provided the committee with a rather considerable amount of hard data on the international competitiveness of U.S. banking institutions and securities companies. I would summarize the results of that simply by saying that, as I interpret the data, what they say to me is that U.S. firms and U.S. institutions are somewhere roughly in the middle of the pack compared to their peers in the other major industrial countries insofar as a cross-section of performance indicators of their competitiveness is concerned. That's the good news.

The bad news is that there is no question in my mind that relative position has deteriorated over the past 10 or 20 years and that if you did an exercise similar to what's done here back then you would have come up with a situation in which the relative position of U.S. firms would have been higher up, and perhaps a lot higher up, on that scale.

Now that brings even into sharper focus some of these issues because it says, again, that, although the de facto operation of the safety net abroad is similar to ours or, if anything, tilts a little further than we would, we have more disruptions in this country and the competitive position and, I would say, the influence of major U.S. institutions operating in the international arena has also slipped.

Now when you put those three things together, they don't in my mind's eye leave you with a very happy picture. So I then asked myself, why? Why is this the case?

In the fourth section of the testimony, I've tried to answer that question. I cited five groups of factors that I think go at least a long way in helping to explain these patterns.

The first is relative elements of our macroeconomic performance in terms of relatively volatile GNP, high and relatively volatile inflation rates, low savings rates, and relatively high cost of capital in this country that in many ways is a direct outgrowth of those factors.

I then cite the declining value of the banking franchise which in many ways applies equally to investment banking as it applies to commercial banking. I suggest that the declining value of the franchise is importantly rooted in technological considerations but is very real nevertheless, and I cite some rather dramatic examples of that. For example, major companies with strong credit ratings can now bypass not only the commercial banking system but the investment banking system as well for very large parts of their day-to-day credit and financing needs; another rather graphic example is the recent entry of AT&T into the credit card business.

I suggest further that process of deterioration in the value of the banking franchise is a bit more advanced in this country than it is in others.

I then turn to my observation that we have excess capacity in banking and finance which to me points to the inevitability of some consolidation, whether we like it or not, and I think we are going to have to manage that consolidation in an orderly way.

Finally, I go back to the anomalies of our current structure of banking and finance in this country and some of the gaps in the supervisory process as I see them.

Taken all together, those are the forces, Mr. Chairman, that lead me powerfully to the conclusion that the case for reform and modernization of the system is very strong indeed.

In the last section of the testimony I get into the so-called safety net question in some detail, and there I want to stress just one point. That is, what I try to do there is go over what I will call the philosophy of the safety net in order to provide some perspective on which of these questions, for example, about deposit insurance have to be looked at. And I stress that in my estimation and the safety net is indeed a package deal, that you cannot look at, for example, deposit insurance in isolation from the other elements; that indeed, the first line of defense regarding the workings and the integrity of the deposit insurance system lies in strong, well-diversified, competitive and capital-rich depository institutions and a strong professionally staffed and politically independent supervisory apparatus.

I think at that point, Mr. Chairman, I would close with just one last thought. That is, as we try to bring greater elements of market discipline into the system, as we try to improve its structure, as we try to improve the supervisory apparatus, we must guard against what I call the seductive appeal of cookbook approaches to problem institutions.

I suggest that with any troubled institution, but especially in the case of large institutions, I believe that both the workings of the safety net and of market discipline will be better served in the context in which the authorities maintain a policy of what I like to call constructive ambiguity as to what they will do, how they will do it and when they will do it.

Thank you, Mr. Chairman.

[The complete prepared statement of E. Gerald Corrigan follows:]

FOR RELEASE UPON DELIVERY EXPECTED
AT 10:00 A.M., THURSDAY, MAY 3, 1990

STATEMENT
(WITH APPENDICES)

BY

E. GERALD CORRIGAN
PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

MAY 3, 1990

Good morning Mr. Chairman. It is a pleasure to appear again before this Committee to discuss the pressing issues facing the U.S. banking and financial system and to stress the need to promptly enact broad based legislation that would reform and modernize the structure of the U.S. financial system and many features of the supervisory arrangements associated with the operation of that system. As has been the case in the past, I want to state at the outset that the views I will express today are my own and, as such, they should not be construed to reflect the views of the Federal Reserve Board or the Federal Reserve System as a whole.

While I will, over the course of my remarks, address all of the issues raised in your letter of invitation, I intend, for the purpose of orderly presentation, to consider these issues in a different sequence than outlined in your letter, starting with the international side of the equation. Since the scope of the material to be covered this morning is very broad, I have attached to my statement a number of appendices which I hope will be of value to the Committee and its staff in the effort to gain a broad perspective on the complex set of issues bearing on how we can best adapt the structure of the U.S. financial system over time.

I. Banking and Financial Structure Abroad

The legal and institutional framework within which banking and financial systems operate in the major foreign industrial countries is of importance to the United States for a variety of reasons. Two are particularly relevant in the immediate context of this hearing: first, international differences in banking structure can have important implications for the competitiveness of U.S. institutions both here in the U.S. and around the world; and, second, international differences in financial structure can introduce complex and potentially dangerous elements of tension into cross-border relationships as they pertain to the rights and privileges of banks and other financial firms to operate across national boundaries.

In order to provide the Committee with an overview of these structural arrangements abroad, the first appendix to this statement provides a broad -- and admittedly oversimplified -- summary of banking structures in the Federal Republic of Germany, Japan, and the United Kingdom as well as a brief description of the main thrust of the Second Banking Directive which will govern banking activities in the European Community. While I will not repeat the thrust of that appendix, I would stress the following major points:

-- first, as a rough approximation, financial structure in the U.K. is quite similar to the structure of other countries with close historic ties to the U.K., such as Canada and Australia;

-- _second_, the prevailing structure in West Germany is very similar to that in the Netherlands and Switzerland and, to a somewhat lesser extent, other industrial countries in continental Europe such as France and Italy.

Looked at in that light, there are, as a rough approximation, three operational models of banking structure in the industrial world today, as follows:

first, the West German-style universal bank in which the full range of banking and financial services is provided within a single legal entity. There is no holding company and separate subsidiaries are used only at the convenience of the bank or when required by foreign regulatory authorities for particular activities conducted outside of Germany. In most universal banking countries, banks may, and often do, own sizable equity stakes in commercial concerns, but the opposite is generally not the case. In other words, manufacturing and other non-financial firms do not typically own and control banks. In this regard, it should also be said that in Germany the practice of banks owning large equity stakes in commercial firms has been the subject of lively political debate from time to time and has been the subject of renewed debate in the recent past;

second, the British-style universal bank, which differs from the German model in that: (1) separate legal subsidiaries are more common; (2) bank holding of shares of commercial firms is far less common, and (3) combinations of banking and insurance firms are far less frequent -- at least to date. But, the operational character of the U.K.-style universal bank has much more in common with the German-style model than it does with arrangements here in the U.S. -- a pattern which will be magnified when the EC banking directive becomes operational;

third, the fragmented systems such as currently prevail in the U.S. and Japan. In these models there are, of course, rigid legal and operational distinctions between classes of financial institutions including, but not limited to, the separation between commercial and investment banking. However, even between the U.S. and Japanese systems, important differences exist, as for example, in the fact that holding companies do not exist in Japan and, in fact, are strictly forbidden by law. It should also be noted that some would suggest that the Japanese system shows some signs of moving toward a British-style universal bank, at least for wholesale banking, securities and other and financial services.

With that general description of the three prevailing models in mind, let me now turn to the major differences between the U.S. system and those in the major industrial countries abroad. Placing aside supervisory issues which I will come to shortly, the major structural differences are as follows:

first, the bank or financial services holding company is, unique to the United States. This is not an incidental difference when it is remembered that in this country such holding companies are almost always the financial and managerial nerve center of the overall entity as a whole. Abroad, those crucial functions -- including the all-important point of access to capital markets -- are almost always housed directly in the lead bank or lead financial institution itself. In this setting, even sophisticated foreign market participants and officials often have a great deal of difficulty understanding structural arrangements here in the U.S. -- a situation that was amplified by the recent Drexel episode;

second, the U.S. is the only major country that does not have a true national banking system. While state initiatives are materially reducing the barriers to national banking in the U.S., even after state initiatives have run their course, we will still be left with a crazy-quilt pattern of state and federal laws and regulations governing various aspects of inter-state banking. Such arrangements in this country stand in increasingly sharp contrast to the situation in the rest of the world, and especially relative to Europe, once the new banking directive takes hold and all duly licensed banking entities -- including subsidiaries of U.S. banking _and_ securities firms -- will be able to freely provide a full range of banking and financial services across the national boundaries of the twelve countries making up the E.E.C. as a whole. No small wonder, therefore, that prominent officials in Europe have some difficulty understanding the restrictions placed on the scope of geographic and product opportunities available to European institutions operating in the U.S.;

third, with the sole exception of Japan -- and that will almost surely change in time whether or not we change -- the U.S. stands out as the only country with a fragmented banking system which severely limits or restricts the type of _financial_ products and services which can be offered by particular classes of institutions. Once again, and leaving aside what changes may occur in Japan over time, the comparative situation in the U.S. will only get worse when the banking directive becomes operational in Europe.

While these differences in structure are important, they become all the more important in the face of related differences in supervisory or, so-called, "safety net" arrangements in the other major industrial countries. In contrasting such arrangements in U.S. with those in other countries there are some striking differences. The most important of those differences are as follows:

> _first_, in every other country studied, consolidated supervision of mainstream banking and financial companies is the rule -- _without any exception_ that I am aware of. It is obviously the case with the German-style universal bank; it is unambiguously the case in practice in the U.K. and it is the case in Japan, even in the face of Article 65. Moreover, in the few cases where commercial companies own banks -- such as in France or Italy -- the supervisory process pierces the "corporate veil" between the bank and the commercial company owning and controlling the bank. Maybe my friends and associates abroad tell me what they think I want to hear, but what they often say is that they are bewildered by those supervisory arrangements in the U.S.

that do not rely on the principle of consolidated supervision;

second, while 20 years in this business has taught me that there are no absolutes, the fact of the matter is that in no case that I have been able to discover are there firewalls in mainstream foreign banking firms that would routinely -- but especially as a matter of law --restrict flows of funds and capital among affiliated entities within the same financial group except in extraordinary circumstances. My tendency to reject absolutes tells me there must be exceptions to this. But, if there are, they are not prominent. For example, the absence of such firewalls is obviously the case for universal banks but it is also the case within financial groups or firms in the U.K., Japan and elsewhere. That is not to say that strict regulations governing certain intra-company activities aimed at customer protection, competitive equality and the facilitation of what we would call functional regulation do not exist, for surely they do exist. Rather, it is to say that in all major foreign countries studied, issues of liquidity and solvency are viewed at the level of the firm as a whole by both regulators and market participants. Thus, firewalls that wholly preclude or limit the flow of funds or capital within the firm are viewed as either unnecessary or counter-productive, except in extraordinary cases when they are imposed by the authorities in an effort to exercise "damage control";

third, in all of the countries studied, mainstream banking organizations as a whole -- including their securities affiliates -- have direct or indirect access to the payment, account and liquidity facilities of their respective central banks. Indeed, even in Japan with its Article 65 separation of commercial and investment banks, the major securities firms have accounts at the Bank of Japan as well as access to its discount window in exceptional circumstances. These global arrangements, among other things, reflect the implicit or explicit recognition that central banks have a unique role and responsibility to help safeguard the effective functioning of financial markets and institutions in order to help guard against disruptions that might have systemic implications;

fourth, in the area of deposit insurance, all of the countries studied have deposit insurance systems which have some similarities -- but some important differences -- compared with the system of deposit insurance in the U.S. The most important similarity is that all such systems studied have formal or legal limits stipulating that only deposits up to a certain size are insured. The most important difference is that, as a rough approximation, appearances would suggest that the private sector has a larger role in the operation and administration of deposit insurance schemes in foreign countries than in the U.S. and, as a result, the direct linkage to the full faith and credit of the government may be less explicit than is the case in the U.S.

From the above, one might be tempted to conclude that in foreign countries depositors are, in de facto terms, less protected than they are in the U.S. or, more broadly, that foreign banking and/or financial firms are somehow less "protected" and, therefore, subject to a greater degree of "market discipline" than is the case here in the U.S. In order to gain some insights into these and related questions the next section of this statement looks at some concrete examples of the workings of the so-called "safety net" in other countries.

II. The Workings of the Safety Net Abroad: Some Case Studies

In order to gain some useful insights into the *de facto* workings of the safety net in other countries, I asked several of my colleagues at the Federal Reserve Bank of New York to research experience in that regard with respect to a number of highly visible cases of troubled financial institutions in foreign countries that have occurred abroad over the past 25 years. The results of their work are summarized in Appendix II. Undertaking this effort was not easy, because in all such instances my associates relied essentially on publicly available information and data. While this approach has its limitations, it is also true that this same information is that which market participants must use in assessing the situation as to how the authorities will behave. On the other hand, this approach, of course, implies that factual details, but especially judgments about motivation, may not always be entirely clear. Yet, for the purposes at hand, even the broad sweep of events surrounding these cases provides a useful insight into the *de facto* working of the safety net in other countries. Moreover, beyond these case studies, I have, from time to time, informally discussed this general subject with many of my colleagues in the major foreign central banks. On the basis of both the more formal research as well as impressions gained in discussions with officials abroad, I would draw the following conclusions concerning the *de facto* operation of the safety net in major foreign countries:

> *first*, with the sole exception of the Herstatt failure in 1974, I am unable to find *any* case in which the authorities have been willing to permit the sudden and disorderly failure of an important banking or non-banking financial institution. (As I will indicate below, the meaning of the word "important" in this context *clearly* is not *limited to size*.) Indeed, the experience with Herstatt and its long and painful aftermath seems to have provided the authorities in all countries with a lasting impression of the grave dangers associated with the sudden and uncontrolled collapse of an important financial institution, especially one with significant -- although again, not large by today's standards -- international operations;
>
> *second*, notwithstanding the presence of legal or formal limits on the extent of deposit insurance coverage, authorities in *all*

foreign countries have, as a matter of general practice, gone to considerable lengths to protect depositors from loss. Indeed, my overall impression is that the number of instances in which depositors -- large or small, insured or not -- have incurred actual losses are few and far between. And, where they have occurred they have been limited to isolated cases or to cases in which the depositor had other relationships -- such as being shareholders -- with the failed institutions. Having said that, it should quickly be added that we have never seen anything abroad even remotely approaching the scope of the thrift industry problem, although the U.K. secondary banking crisis had many structural characteristics in common with the thrift problem in the United States;

third, in a number of prominent cases, some covered in the appendix and some not, the authorities, including central banks, have moved swiftly and decisively to intervene in the cases of troubled non-bank financial institutions -- here too, some conspicuously small in size. Such interventions have involved the use of central bank credit facilities, public monies and, at times, a degree of moral suasion, if not arm twisting, that, from my experience, simply would not work in the U.S.

In all such cases, public intervention was apparently motivated by concerns about systemic risk, but, as suggested above, in several instances the troubled institution was not particularly large and, in other cases, were distinctly "non-bank" in character.

fourth, in a number of prominent cases, again some covered in the appendix, others not, the "rescue" efforts undertaken by the authorities entailed a joint effort with public and private entities. Indeed, at the risk of over-generalization, it seems fair to say that the foreign official institutions seem better able to call upon, if not insist upon, the participation of private entities in such rescue operations than is the case in the United States. In a number of cases, though, including the silver market crisis in 1980, the LDC debt crisis, the Continental Illinois bank problem and the 1987 stock market crash, joint public and private actions were very much in evidence in the U.S. Nevertheless, my impression -- unscientific as it is -- remains that private institutions either are more willing, or feel more compelled, to participate in stabilization or rescue efforts in foreign countries than they are in the U.S.

If that impression is correct, it raises the obvious question as to why private foreign financial institutions play a larger role in such rescue operations than is the case in the U.S. Here one can only speculate that part of the answer may simply lie in history: that is, it's been done that way for many, many decades. It may also be true that where a handful of banks dominate national banking systems, that handful of banks feel more directly threatened by potential dangers of a systemic nature than do institutions here in the U.S. Finally, when the headquarters of that same handful of banks are typically located only minutes away from the central bank, and when so few must agree on a particular course of action, it is obviously much easier to bring things together than it is here in the U.S. For example, there is some substance to the suggestion that one of the most potent tools available to the Bank of England in time of stress is the Governor's eyebrow!!

In summary, experience abroad suggests that authorities in foreign countries behave in a manner very similar to the authorities in this country when faced with problems in financial institutions. If anything, the protections provided by authorities abroad seem, on balance, to go further than might reasonably be expected in this country. This, of course, is another way of saying that institutions in this country are subject to at least the same -- if not a greater -- degree of market discipline than is the case abroad.

Yet, it seems clear to me that over the past 15 years, the U.S. has had more than its share of banking and financial market disruptions. In those circumstances, a question naturally arises as to why we have had, in relative terms, so many such disruptions in recent years.

For many, the answer to that question comes easily: too big to fail; *de facto* full insurance of deposits; overextension of the safety net; not enough market discipline. While there is some truth in all of these generalizations, the answer clearly is not all that simple. One thing, however, strikes me as quite clear: namely, given the experience in other countries, it is very hard to make the case that the *de facto* operation of the safety net in this country, in and of itself, is accountable for the problems and strains in our financial system. Even greater market discipline may be needed, but the evidence as a whole suggests there is something much more fundamental at work.

To complete the analysis of the international side of the equation, one more piece of the puzzle must be put in place. That piece, of course, relates to the international competitiveness of U.S. banking and financial institutions.

III. The International Competitiveness of Major U.S. Financial Institutions

In recent times, the subject of the international competitiveness of U.S. financial firms has received increasing attention. In order to shed some further light on this subject, my associates at the Federal Reserve Bank of New York have been engaged in an effort to more systematically analyze both the myths and realities of this situation. As a part of that effort, I have attached to this statement as Appendix III a paper summarizing the results of some of this work. That paper provides a summary of selected performance traits of a cross section of 51 major and internationally active banking and securities companies from seven major industrial countries. Before attempting to summarize the results of this analysis, allow me to emphasize a number of qualifications about these data and the delicate task of drawing reasonable and reasoned conclusions from the data:

first, due to substantial differences in regulatory, accounting and tax rules in the respective countries, many of the cross-border comparisons are seriously distorted if taken at face value. Indeed, to properly interpret the data, one must have at least a general sense of these accounting and related differences in order to have the proper perspective on the various statistics. To cite just an example or two:

-- I know that the underlying capital position of one or more groups of foreign banks is a good deal stronger than the raw statistics would suggest, in part because accounting rules and tax rules allow some groups of banks a great deal of flexibility with regard to the accounting for, and accumulation of, so-called "hidden reserves";

-- I know that the statistics on

profitability are seriously distorted -- perhaps more so than any other grouping of these data -- in a way that tends to understate the "core" profitability of U.S. banks relative to one or more of the other groupings of national banks;

second, even aside from data problems, the information contained in this appendix is limited in the extent to which it provides decisive insights into international competitiveness of one national group of banks versus others. In part this is true because of certain individual institutions in this country and abroad that stand out to such an extent from their domestic peers that they seem to defy these international comparisons;

third, under the best of conditions, aggregate performance data at the level of the individual firm tell only a part of the story. Accordingly, my associates are also seeking to investigate international competitiveness of U.S. firms in a number of specific but discrete markets, ranging from foreign exchange and interest rate swap markets to retail banking. This, of course, is a very difficult undertaking but the initial impression one gets from this line of approach is that U.S. financial institutions continue to be seen in the markets as strong and imaginative competitors in many individual product and service lines, especially in the more sophisticated and innovative areas. This work has a long way to go but if it is successful, we will find an appropriate vehicle to make the results public sometime late this year or early next year.

With those qualifications in mind, my personal interpretation of the data and information contained in Appendix III leads me to the following main conclusions:

-- first, on balance, I would place the U.S. banks somewhere roughly in the middle of the pack of the national groups of banks studied in terms of all the performance measures studied;

-- second, looking at U.S. banks and securities firms combined, relative to the German-style or British-style universal bank or relative to the combination of Japanese banks and securities companies, I would be inclined to a similar "middle-of-the-pack" or perhaps slightly weaker relative ranking of U.S. institutions;

-- third, while hindsight in this regard is far from "20/20", my strong hunch is that a similar exercise performed 10 or 20 years ago would have provided a result in which the rankings of U.S. firms would have been higher and perhaps materially higher. In other words, while the data may suggest that U.S. firms are still quite capable of holding their own in an international context, there is no doubt in my mind that as a group their position has slipped.

Before turning to the final two sections of this statement, allow me to summarize its main points thus far. First, the basic structural and supervisory framework governing the operations of U.S. banking and financial firms is materially different than it is in all other countries studied and, as things now stand, will become increasingly so in the foreseeable future. Second, despite sharp differences in key elements associated with the structure and design of the so-called safety net, the _de facto_ operation of the safety net -- including the extent of depositor protection -- appears quite similar across the industrial countries. If anything, market discipline may, on balance, play a larger role in this country. Yet, over the past 15 years, the U.S. has had more than its share of banking and financial disruptions, therefore casting some doubt on the oft cited proposition that these problems have as their _basic cause_ the tendency for authorities in this country to "bail out" troubled financial institutions. Finally, the analysis of the international competitiveness of U.S. financial firms places such firms somewhere in the middle of the pack, a position that almost surely reflects a deterioration in standing from 10 or 20 years ago.

Of the many questions raised by these interim conclusions, two stand out: first, if the _de facto_ operation of the safety net is quite similar across countries, why have we in the U.S. witnessed what strikes me as a disproportionate number of financial disruptions in recent years, and second, what accounts for the less than strong overall performance of U.S. firms in an international setting especially if, as I believe, that performance has slipped in the last decade or more?

IV. Underlying Factors Influencing the Performance of Banking and Finance

At the risk of great oversimplification, it seems to me that there are five major reasons why we see a U.S. banking and financial system characterized by the dual conditions of recurring bouts of instability and competitive slippage both at home and abroad:

> The first major factor which is helping to shape these trends in the banking and financial sector -- especially in a comparative international context -- is macro-economic performance and policies. Over the last decade and one half volatility in GNP, high and volatile rates of inflation, low savings, and our weakened external position have all contributed to a financial environment that breeds difficulties at home and contributes to slippage abroad. With regard to the latter, there is simply no question in my mind that one of the key reasons for the emergence of the Japanese financial institutions as so large a force in global markets is rooted in Japan's strong overall economic and financial performance over much of that period;

second, for a variety of reasons -- many rooted in technological advances in telecommunications and in the information sciences -- the historic value of the banking franchise is under great pressure. The institutionalization of savings, the securitization of financial assets and liabilities, the easy access to information about creditworthiness of individual borrowers, and even the "800" telephone number are all symptomatic of a rapidly changing banking and financial environment which has unquestionably undercut the once considerable value of the banking franchise. This tendency is reinforced by the fact that due to these same technological and informational factors, the "shelf life" of most innovations in banking and finance is very short in duration.

As one reflection of this, the most creditworthy corporate borrowers can now fully bypass the entire banking and financial system for many of their day-to-day credit needs. For example, we now have instances in which such firms with particularly strong credit ratings are able to directly place their own commercial paper with institutional and other investors, thereby by-passing not only the commercial banking system -- once the exclusive source of such short term credit -- but also the underwriting and placing capabilities of the investment banking industry. Now that's disintermediation!!

As another, more recent, example, AT&T -- with its vast financial and technological resources -- has recently entered the credit card business and in the process is offering consumers very attractive terms on such cards in a context in which there would appear to be potentially very considerable synergies between this line of business and AT&T's traditional lines of business.

The diminished value of the banking franchise in this country appears, for a variety of reasons, to be somewhat more advanced than is the case in other countries -- although that may not last. For example, capital markets are not nearly as well developed in Japan as they are in the U.S., the result being that the role of the deposit intermediary is still more central in

Japan than it is in the U.S. Some would also suggest that the very close relationships between banking and large industrial firms in other countries works in the direction of helping to preserve the banking franchise. Finally, some would also suggest that the authorities in other countries may tilt a bit in the direction of trying to preserve the value of the franchise where that is possible.

In suggesting that the value of the banking franchise has declined, I am not suggesting that the developments that have given rise to this situation are all bad. To the contrary, most of them are very good in terms of efficiency, reduced costs, greater competition and vastly increased choices for savers and investors. But, taken as a whole, these developments have clearly and irreversibly changed the rules of the game in a manner that, at the very least, makes for difficult transitional problems for the affected institutions and markets;

third, partly because of the competitive implications of the technological and market forces described above and partly because we have so many financial institutions and so many classes of financial institutions that compete with each other, we now have, in my view, excess capacity in large segments of banking and finance. This same condition appears to exist internationally, at least in some segments of wholesale markets. The symptoms of this condition abound in razor-thin spreads, pinched margins and, perhaps especially, in the troublesome manner in which we see vast amounts of very short-term churning and trading in so many segments of the financial markets. As I have said on other occasions, this situation seems, at times, to create a vested interest in volatility, since opportunities for trading profits at the level of the individual firm or individual trader seem greatest when swings in interest rates and exchange rates are also the greatest. Whatever else one can say about this, it reinforces the unrelenting preoccupation with the short run we see in financial markets and in corporate America more broadly.

What may be even more important, however, is that if my conjecture about excess capacity in financial services is correct, it would clearly imply that we will have to go through a period of at least some consolidation in banking and finance. In saying this, I am not suggesting for one minute that we will end up with a highly concentrated banking and financial system along the lines of what we see in many other countries. The trick, of course, is to shape public policies in a manner that provides the highest assurance that the process of financial market consolidation in the U.S. occurs in an orderly and equitable manner consistent with broad national goals and priorities.

The fourth factor I would cite in this regard is the direct subject of these hearings: namely, the outdated legal and institutional framework within which the U.S. banking and financial institutions operate. As the first section of this statement makes clear, the U.S. banking system is simply out of step with the rest of the world and, more importantly, it is out of step with the realities of the marketplace. Even more importantly, the system as now configured may be risk and accident prone, rather than risk adverse. Fragmentation alone may produce that result since fragmentation can inhibit diversification of risks on both sides of the balance sheet. Similarly, the inescapable tendency of firms and market participants to push the spirit and the letter of law and regulation to the limit in a fragmented system brings with it its own elements of risk and perversity. Finally, fragmentation inevitably brings with it the tendency to shift activities offshore which, in turn, entails loss of income, loss of jobs and, in some cases, the loss of some element of managerial and supervisory control.

A final factor I would cite that bears particularly on the relatively high incidence of financial disruptions in this country is what is often called gaps or lapses in the supervisory process. The most important illustration of this, by far, is to be found in the thrift industry situation which was far, far more a fatal flaw in the legal and supervisory process than it was in the architecture of the deposit insurance system. More generally, I believe at least something of a case can be made that the highly fragmented nature of the U.S. banking and financial system may, in its own right, contribute to gaps in the supervisory process.

In considering all the factors cited above, it should be noted that, for the most part, they are secular in nature and, as such reflect "outside" forces impacting on the environment within which banking and financial institutions operate. However, one should not conclude from this that all of the elements that have produced strains in banking and finance are of this nature. For example, there are internal forces -- such as the current problems in real estate markets or the overhang in the market for high yield securities -- which importantly reflect a lack of prior restraint on the part of some market participants. Similarly, we have seen all too many instances of poor management, overly aggressive strategies and, unfortunately, elements of highly questionable behavior, including some outrageous instances of outright criminal activity.

But, problems growing out of poor management, recklessness or even illegal activities -- outside of the thrift industry problem -- are relatively few in number, although at times highly visible in nature. Moreover, existing regulatory and legal sanctions can probably cope with these problems, especially with the strengthened provisions in FIRREA. The more generalized situation having to do with the competitive well-being and the underlying stability of the banking and financial system must be looked at in the broader light of the other issues raised in the earlier parts of this statement.

V. Reform and Modernization of the U.S. Banking and Financial Systems

In approaching the reform and modernization of the U.S. banking and financial system, this Committee and the Congress as a whole can, as I see it, choose among four basic alternatives or models: (a) the current fragmented system; (b) the German-style universal bank; (c) the British-style universal bank, and (d) the financial services holding company approach along the broad lines suggested in my 1987 essay, Financial Market Structure: A Longer View. For my part, I would quickly rule out the status quo and the German-style universal bank. In the latter case, I would come to that conclusion because of my discomfort about the nature and extent of the "banking-commerce" linkages that the German-style universal bank seems to imply.

In considering the relative merits of the financial services holding company versus the British-style universal bank, there are three major areas of potential difference -- aside from supervisory arrangements which will be considered later. Those areas of difference are: (1) the definition and scope of financial activities that can be conducted within the group or company; (2) the presence or absence of the holding company itself, keeping in mind that these holding companies are, in a U.S. context, the financial and managerial nerve center of the company as a whole; and (3) the nature and extent of the rules and regulations limiting or preventing various classes of transactions or other relationships between the various component parts of the entity as a whole -- that is, Chinese walls and/or firewalls. While it does not necessarily follow, there may also be differences as they relate to whether and under what conditions the entity or its parts may have access to the account, payment and liquidity facilities of the central bank.

In choosing between these two alternatives, I would still have a preference for the financial services holding company, particularly given where we are, as a nation, in terms of the evolution of our attitudes on these matters. Having said that, if I had the liberty of starting with a clean slate, I might well opt for the British-style universal bank. In either case, I strongly believe the approach must be reciprocal along the broad lines of the philosophy of the Proxmire-Garn bill. That is, for example, if banks can get into the securities business as a general matter, securities companies -- with some possible exceptions -- can get into the banking business. In the case of either model I also believe there must be strong Chinese walls which provide protections against conflicts of interest, unfair competition and certain kinds of "tie-ins". Similarly, I believe there should be reasonable protections against undue concentrations, recognizing, of course, that some consolidation in banking and finance will occur under any circumstances. Finally, I believe that there must be an instrumentality that would be responsible for the ongoing task of defining and limiting the scope of activities which can be conducted in the group as a whole.

There are, however, three areas in which my personal views may place me somewhere between a distinct minority and a voice in the wilderness -- and probably closer to the latter. They are:

> first, I believe, with more conviction than ever, that we must have a system of consolidated supervisory oversight of any company that has direct or indirect access to the "safety net". To me, the minimum that this entails includes: (1) systematic reporting of financials for both on- and off-balance sheet activities at the level of the holding company and all of its subsidiaries and affiliates; (2) minimum capital standards including those for the holding company level, and (3) stand-by authority for inspectors or examiners to do on-site reviews in any entity within the group, including the parent holding company.
>
> Where the dominant company is a banking entity, the Federal Reserve would be responsible for consolidated oversight. Where the dominant firm is a securities entity, that task could be given to the

S.E.C. Functional supervision, much as we have it today, would apply to the component parts of the group as a whole.

To me, the world we live in, together with the nature of the potential systemic risks we face in banking and finance demand that we move in this direction. Some two and one-half years ago I summarized for this Committee the thinking that led me to this conclusion. I have appended to this statement, as Appendix IV, an excerpt from that earlier testimony on this subject. At this juncture, all I would add is that events since then, including the Drexel episode, have strengthened my views in this regard.

Second, I remain strongly opposed to the merging of banking and commerce and any arrangements that would even remotely contemplate the ownership and control of bank holding companies or financial services holding companies containing depository institutions by commercial concerns. Here, too, on an earlier occasion, I spelled out before this Committee the reasons for my concerns in this regard and I have provided an extract of that earlier testimony as Appendix V.

Notwithstanding the observations I made earlier about the diminished value of the banking franchise and the inroads of commercial firms into financial businesses, I still look with concern, if not alarm, at the economic, financial -- and perhaps even social -- implications of Exxon owning Chase Manhattan, Ford owning Citicorp, or RJR Nabisco owning J.P. Morgan. Obviously, those examples draw on more than a little hyperbole in order to stress the point. But, once that door is opened, there is absolutely no way to anticipate how events will shake out over time. Therefore, and absent that compelling public policy reason I spoke of in my earlier testimony, I would strongly urge that we maintain a strict separation of banking and commerce.

It may be, in appropriate circumstances, that a case can be made that a margin of added flexibility could be provided whereby a bank or financial services holding company could own somewhat more than 4.9 percent of the equity of a non-financial concern and vice versa. However, even this would have to be approached with care in view of the often razor-thin distinctions that now exist between various classes of "equity" and "debt" securities keeping in mind that the issue here is not arithmetic, but influence and control.

Similarly, some added flexibility might be considered where a bank or financial services holding company owns even a "controlling" interest in a non-financial firm so long as that latter firm is, in some sense, "*de minimis*" relative to the bank or financial services holding company as a whole. However, this too would have to be approached with great care, keeping in mind the extent of the problems that can arise, for example, with a seemingly "*de minimis*" real estate development company. The need for great care in this regard is strongly reinforced by case after case which illustrates that the well-being of the company as a whole cannot be safely disentangled from problems or adversities affecting an affiliated company no matter how thick the firewalls nor how well constructed the legal separation. Indeed, in times of stress, not only does the marketplace fail to generally accept these distinctions, but the directors and managers of the firms under stress don't accept them either.

third, as suggested above, I have real worries about "firewalls" becoming "walls of fire". For these purposes, I want to distinguish between: (1) "Chinese walls" which, like regulations 23-A and 23-B, seek to protect against conflicts and unfair competition and/or other such regulations governing "normal" business relations among affiliated companies, and (2) "firewalls" which strictly limit or prevent the mobility of funds and capital among affiliates. My problem here is not with well-conceived "Chinese walls" but rather with ill-conceived "firewalls".

From a broad public policy perspective, the case for very thick and very high firewalls rests heavily on concerns about overextension of the safety net, threats to the deposit insurance fund and ultimately to the taxpayer and the more subtle, but very important, moral hazard dilemma. Taken individually or collectively, these issues cannot be dismissed lightly.

Just as we cannot dismiss these concerns lightly, neither can we dismiss what the marketplace tells us both here and abroad. And, what the marketplace tells us with almost unfailing regularity is that in times of stress, some parts of a financial entity cannot safely be insulated from the problems of affiliated entities. Investors, creditors and even managers and directors simply do not generally behave in that fashion and the larger the problem the less likely they are to do so. Because this pattern of behavior seems so dominant and because the authorities throughout the rest of the industrial world generally frame their policies with this in mind, there seems to me little doubt that taken to an extreme, absolute firewalls can aggravate problems and instabilities rather than contain or limit them. Indeed, I don't have to stretch my imagination or my memory very far to find examples in which a heavy handed approach to firewalls could easily have been the source of significant problems.

There is also a matter of logic here: that is, if we are prepared to accept the proposition that greater flexibility in allowing combinations of entities providing financial services makes sense, we must be saying, at least implicitly, that such combinations make sense on economic grounds. Otherwise the exercise is sterile. On the other hand, if we say such combinations are permissible but then insist on firewalls that are so thick and so high so as to negate the economics of the combination in the first place, the net economic result will also be sterile.

As with most things, the whole subject of firewalls has to be viewed in context. For example, in the context of an individual firm with very strong capital resources, presumably the case for firewalls is greatly diminished, if not eliminated. On the other hand, during a transition period in which financial structure is changing -- especially if that process of change is accompanied by some consolidation -- a conservative _interim_ approach to firewalls may be quite appropriate. But, even in those circumstances, I believe care is needed to insure that we provide enough flexibility so that firewalls do not, in fact, become walls of fire.

VI. Safety Net Arrangements

As I see it, any discussion of the federal safety net associated with the banking system and individual banking institutions must start with the fact that such institutions are subject to a higher degree of regulation and supervision than is the case for most other kinds of private enterprise. While the specific points of emphasis of such regulation will vary from time to time and place to place, the basic rationale for such arrangements rests on two elements: first, the unique nature of the fiduciary responsibilities of such institutions, and second, the unique elements of systemic risk present in banking and finance. While some bankers are not shy to complain about the burdens of some forms of regulation, all accept the premise as to why banks are regulated in the first instance. And, most recognize that in exchange for carrying the burden of regulation, banking institutions enjoy certain benefits not normally accorded by markets or society to other classes of institutions. For example, the mere presence of the supervisory apparatus is one of the reasons that the marketplace allows banking and financial institutions to operate with a higher degree of leverage than most other classes of institutions -- a result that is seen as economically and socially desirable because of its capacity to help mobilize savings and investment and thereby foster economic growth and rising standards of living.

In addition, and in further exchange for accepting the burden of regulation, society conveys to banking organizations certain other direct benefits: deposit insurance, access to the liquidity facilities of the central bank and, not the least, access to the account and payment facilities of the central bank. The safety net must, therefore, be viewed as a package deal but one in which it is explicitly recognized that bankers -- knowing that their business is essentially the business of public confidence -- will conduct their affairs in a safe and prudent manner consistent with their fiduciary and societal responsibilities.

Looked at in that light, officially imposed prudential standards in such areas as capital adequacy, liquidity management, lending limits, etc. -- as well as the official examination process itself -- are aimed, in part, at helping to establish an overall framework within which such institutions can compete and flourish, but do so in a context that protects the safety and stability of the system as a whole. But, and this is a very large but, the first and foremost responsibility for the safe and prudent operation of individual institutions rests with the directors and management of those institutions -- not with the authorities.

Because the safety net, by its very nature is a package deal, possible approaches aimed at improving the manner in which it functions must be viewed in that overall context. For that reason, we must be careful about approaches which focus largely or exclusively on any one aspect or feature of the safety net to the exclusion of others. For example, while there are opportunities to improve the workings of the deposit insurance system, the deposit insurance system can only be as effective -- and as cost effective -- as the safety net as a whole, especially its supervisory components. Indeed, at the end of the day, I would argue that the broad approach to supervisory policy -- including the examination process itself -- is the foundation upon which an effective deposit insurance system must rest.

In the current setting, much of the debate about the safety net in general, and the deposit insurance system in particular, centers on wholly understandable concerns about the cost of "bailing out" troubled depository institutions. Within that context, there is a particularly sharp edge of debate about the school of thought that focuses on the suggestion that some institutions are too big to fail and the implications of that for the so-called moral hazard problem. In other words, how do we secure the right balance between market discipline on the one hand and protections against severe -- if not systemic -- disruption and dangers on the other, especially in a setting in which the business of banking and finance are subject to the enormous competitive and external challenges described earlier in this statement?

To my way of thinking, the most essential part of the answer to that question lies in the combination of private actions and supervisory policies which will strengthen the financial and capital positions of individual institutions, perhaps especially those institutions that by their size or character present the greatest risks to the stability and well-being of the system as a whole. In this regard, it is perhaps worth noting that over the past decade we have, in fact, seen a material strengthening of the financial position of the largest banking organizations here in the United States.

To illustrate this, I have included in the appendices to this statement a series of charts depicting key indicators of the performance of the 10 largest banking organizations in the U.S. over the past decade. In providing these data, I am mindful of the problem of having picked the 10 largest as opposed to the 12 largest or the 5 largest or the 25 largest. I assure you, Mr. Chairman, the number 10 was chosen only because it's a nice round number. Beyond that, it has no significance whatsoever. And, if a different number were used, the results would not be affected in any material way.

Taken as a whole, these charts capture rather well both the problems and the progress these institutions and the industry at large have experienced over the last 10 years. They also capture the radically changed character of the banking business over the decade. But, perhaps more than anything else, they capture the very sizable and very necessary buildup in capital resources over the period. To cite just two examples:

-- since 1979, the absolute level of primary capital of these institutions has about quadrupled, reaching almost $80 billion at year-end 1989, while the primary capital ratios have about doubled;

-- as of year-end 1989, the BIS tier one risk-based capital ratios of these institution are already well above the 1992 minimums, using the more stringent 1992 definitions of capital.

In pointing to these data, I do not want to leave the impression that I am satisfied that all that needs to be done in strengthening the financial position of these and other institutions has been done, for it has not. Indeed, in the current environment, all institutions should be working toward overall capital positions that are considerably in excess of regulatory minimums. Indeed, I would argue that in the current environment in which the domestic and international marketplace rewards strength, the competitive position of internationally active U.S. banking organizations would be improved as they move toward and hopefully to the top of the ladder in terms of their comparative capital strength.

Within the context of public and private initiatives that will continue to improve balance sheet and capital strength, the task of possible reforms of the deposit insurance system becomes far less formidable. Since the Treasury and the Federal Reserve are both looking into the subject of deposit insurance reform, I don't want to muddy the waters by getting into a bill of particulars on deposit insurance reform on this occasion. However, I will say that in my estimation the single most serious abuse of the deposit insurance system has been the misuse of brokered deposits. As a practical matter, fixing this problem without destroying the legitimate business of money and deposit brokerage will not be easy. In principle, however, what we should be striving for is a system in which the $100,000 deposit insurance limit should apply per individual or per entity. In mentioning this particular area of concern, I don't want to leave the impression that I am of the view that there may not be other constructive areas in which reforms might be considered. That is not my view. But, as I have stressed earlier, the first line of defense regarding the workings and integrity of the deposit insurance system lies in strong, well diversified, competitive and capital rich depository institutions and in a strong, professionally staffed, and politically independent supervisory apparatus.

In this connection, we must also guard against the seductive appeal of "cookbook" approaches to problem institutions. With any troubled financial institution, but especially in the case of large institutions, I believe the workings of both the safety net and market discipline will be better served in a context in which the authorities maintain a policy of what I like to call "constructive ambiguity" as to what they will do, how they will do it and when they will do it. In saying this, I recognize that financial market participants don't like uncertainty, but that's just the point!! Moreover, while I fully understand the yearning in some quarters for the cookbook approach to problems in financial markets or institutions --

large institutions especially -- I regret to say that in my judgment such a cookbook does not and never will exist. The circumstances associated with a particular case, the setting in which it occurs and the assessment of the relative costs and benefits of alternative courses of action will always have to be looked at case by case. But in no case should it be prudent for market participants to take for granted what actions the authorities might take and certainly in no case should owners and managers of troubled institutions -- large or small -- conclude that they will be protected from loss or failure.

VII. Conclusions

Mr. Chairman, my statement and its appendices have covered an enormous amount of ground. In the interest of your patience I will not attempt to summarize at this time. But, in closing, allow me to briefly stress three points. First, while I can readily understand why the thrift industry problem may have dampened the enthusiasm of the Congress to tackle the issues I have discussed today, it seems to me that the thrift industry problem tells us rather clearly that the longer a problem festers, the worse it becomes. With or without progressive legislation, the period ahead in banking and finance will not be easy. But with progressive legislation our prospects are so much better for consumers, for businesses, for competitiveness and perhaps most of all for the stability and soundness of our financial markets and institutions.

Second, over the course of my statement, I have deliberately stayed away from the subject of possible reforms in the structural arrangements associated with the supervisory system. I have done that because I firmly believe that such reforms should follow from reform of the banking and financial system -- not precede it. But, and at the risk of appearing self-serving, I do want to repeat my utter conviction that when reform of the supervisory structure does occur, it should proceed in a manner that preserves a central -- but by no means exclusive -- role for the Federal Reserve. It seems to me that experience here and throughout much of the world tells us in rather uncertain terms that helping to ensure the safety and soundness of banking and financial markets and institutions, and helping to stabilize such markets and institutions in the face of adversity are functions that relate directly to the very essence of central banks.

Finally, over the course of this statement, I have drawn heavily on experience and conditions in other countries. Having done that, I don't want to leave the impression that I feel any compelling case to duplicate precise arrangements in any other country or group of countries, because I don't. To be sure, we have some work to do in this country in adapting arrangements in a changing global setting; to be sure, we face some difficult transition problems in the period ahead; to be very sure, none of this will be easy. But, as we face those challenges, let us not lose sight of our strengths: our financial markets are still the bellwether of world financial markets; our banks, investment banks and insurance companies are still the leaders in constructive innovation, and our financial markets and institutions are still the world's safe harbor. Let's keep it that way!!

Thank you.

Appendix I

Financial Structure and Supervision in Germany, Japan, and the United Kingdom

Overview

This appendix provides a brief description of the financial systems in Germany, Japan, and the United Kingdom. Germany has a universal banking system in which most financial services firms are considered banks and may engage in a wide array of banking and securities activities. Like the United States, Japan has fairly strict separation between banking and securities underwriting, dealing and brokering activities, but the financial system is currently undergoing considerable change. The United Kingdom does not have formal restrictions on the range of financial services provided by individual financial firms, and the provision of services has become increasingly integrated in recent years. Schematic representations of the major financial institutions and the important supervisory relationships follow the descriptions of each financial system. This appendix concludes with a discussion of the European Community's policy concerning the range of services that can be provided by EC and non-EC banks after 1992.

1. Germany: The Universal System Model

1.1 Services provided by major financial institutions

Germany operates under a universal banking system in which any institution engaging in a banking activity is defined as a bank. Banking activities include the taking of deposits, consumer and commercial lending, securities underwriting and trading, operating a mutual fund, and investment counseling. Any licensed bank can engage in any banking activity and is permitted large, permanent equity holdings ("participations") in commercial, industrial and insurance companies. Under German law and regulation, all banking activities take place within individual departments of the bank.

The commercial banking sector is composed of approximately 300 banks that operate as true universal banks, offering a wide range of financial services. The so-called "big three" banks--Deutsche Bank, Dresdner Bank and Commerzbank--have large retail deposit-taking and lending operations, but they also focus on wholesale corporate lending, payments transactions, securities trading and underwriting, and foreign currency transactions.

The big three banks have a dominant position in the German capital markets and are moving aggressively into other domestic and global markets. Deutsche Bank has recently established its own life insurance subsidiary, and Dresdner Bank has a retail marketing joint venture with Allianz, Europe's biggest insurer. Deutsche Bank acquired an Italian banking subsidiary, Banca d'America d'Italia, in 1986 and a British merchant bank, Morgan Grenfell, in 1989. Commerzbank has a majority interest in an Irish bank, Allied Irish Bank. The big three are positioning themselves to move into East Germany following reunification and across the European Community after 1992.

Various other banking institutions, which may offer a wide range of services, have chosen to be more narrowly focused, filling particular niches in the German financial system. Other commercial banks, mortgage banks, building and loan associations, and so-called "private bankers" operate regionally or specialize in providing particular financial services such as consumer or trade credit. Extensive networks of savings banks and cooperative banks provide real estate loans and short-term consumer and business credit, funding themselves primarily with retail deposits. The two networks tie their respective local institutions to regional clearing banks. These regional clearing banks are themselves tied to central clearing banks that conduct the full range of permissible banking activities.

1.2 Regulatory supervision and protections in marketplace

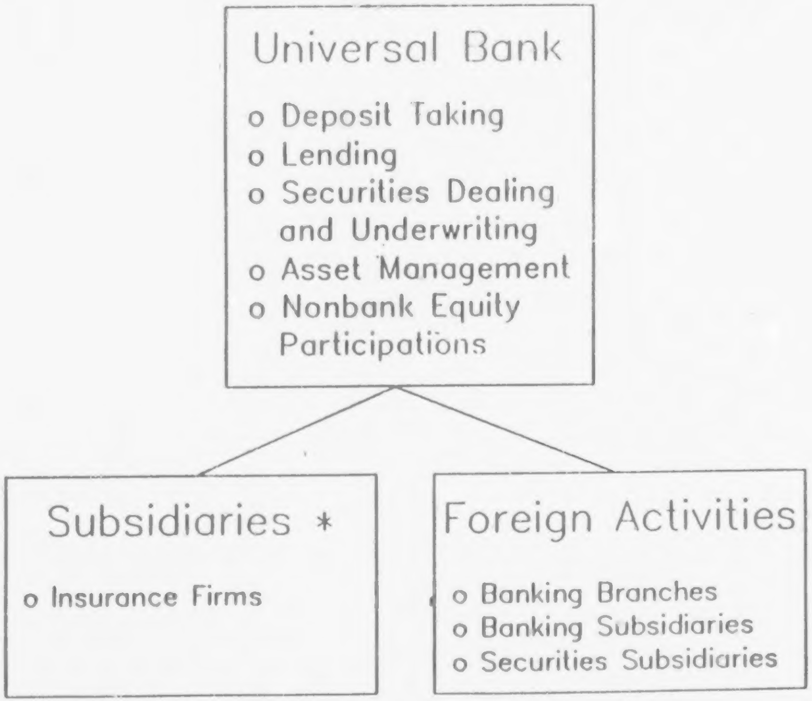
All institutions that engage in banking activities fall under the joint oversight of the central bank, the Deutsche Bundesbank, and the Federal Banking Supervisory Office (FBSO). The Bundesbank sets reserve requirements, provides liquidity through discounting and Lombard loans, serves as a clearinghouse, and conducts inspections of banks. The FBSO licenses banks, sets capital and liquidity requirements, and, as a matter of law, is the direct supervisor.

Universal banking does not impose a holding company structure or "firewalls" between departments that might restrict the flow of funds and capital within the bank. When a bank and insurance company are affiliated, the entity is regulated on a consolidated basis by the FBSO if the bank is the parent company. The primary insurance regulator, the Federal Insurance Supervisory Office, supervises the consolidated entity if the insurance company is the parent.

The professional banking associations also play a significant role in the regulatory structure of the financial system. Various groups of banks have formed these associations to administer private deposit protection funds and to represent their interests in discussions concerning bank regulations. Since the German government must by law consult with these associations when new or amended banking regulations are being considered, the associations have obtained semi-official status.

The largest of these associations is the Federal Association of German Banks, which represents the majority of commercial banks. Members of the association may also become members of the Deposit Protection Fund. Participation is voluntary, but most privately owned banks belong to the Fund. Participating banks must also belong to the Auditing Association of German Commercial Banks, which means they must submit to its audits and meet certain standards with respect to capital, management qualifications and current earnings. Coverage per depositor is up to thirty percent of the bank's capital. The savings banks and cooperative banks have associations that have set up similar deposit protection plans.

WEST GERMAN UNIVERSAL BANKS



Universal Bank

- o Deposit Taking
- o Lending
- o Securities Dealing and Underwriting
- o Asset Management
- o Nonbank Equity Participations

Subsidiaries *

- o Insurance Firms

Foreign Activities

- o Banking Branches
- o Banking Subsidiaries
- o Securities Subsidiaries

* Seperate subsidiaries exist only where required by foreign authorities or, on occasion, when adopted for convenience.

WEST GERMAN REGULATORY STRUCUTURE

Federal Banking Supervisory Office

Primary Supervisor for all Universal Banks

Bundesbank

- Central Bank
- Operates Clearinghouse
- Inspections of Universal Banks

Federal Insurance Supervisory Office

Primary Supervisor for all Insurance Firms

Professional Banking Associations

Private Deposit Insurance Funds

2. Japan: Structured Rigidity Undergoing Change

2.1 Services provided by major financial institutions

The Japanese financial system is highly compartmentalized, with each type of institution limited to a particular range of activities, due to the legal separation of banking, securities activities, and commerce. Banking services are provided by commercial banks and various specialized financial institutions for small business, agriculture, forestry and fishery. Securities firms perform the underwriting, dealing and brokering in the corporate capital markets. Licensed insurance firms have the exclusive right to broker and underwrite their products and can also engage in trust management.

As a strict legal matter, the separation of banking and commerce is the same in Japan as in the United States. Japanese banks, like US bank holding companies, are not allowed to hold more than 5.0% equity in other companies. However, by U.S. standards the shares in most major companies -- banks and non-banks alike -- are relatively closely held. Thus, patterns of shareholdings among major banks and cross-holdings among banks and commercial concerns are quite different from patterns in the United States.

The commercial banking sector is characterized by a high degree of specialization. The sector is generally defined to include regional banks, foreign banks, trust banks, long-term credit banks and city banks. These institutions are distinguished from each other by their relative size, the maturity of their assets and liabilities, the geographical reach of their operations, and their services (e.g., ordinary banking versus trust banking).

Japanese banks can deal in government securities and foreign exchange but are prohibited from underwriting, brokering and dealing in corporate bonds and equities under Article 65 of the Securities and Exchange Law of 1948, the Japanese equivalent of the Glass-Steagall Act. Article 65 dealt with a specific list of securities that existed in 1948, and regulators have since handled newly developed instruments on a case-by-case basis. As this process evolved, banks have been allowed to deal in commercial paper, which are considered discount bills, and certain futures and options contracts.

Japanese banks are precluded by law from adopting holding company structures--a prohibition adopted as a political reaction against the Zaibatsu conglomerates that dominated Japanese industry before World War II. Dealing in government securities, commercial paper, foreign exchange, futures and options is generally conducted within departments of the banks. Other activities-- such as investment management, credit card services, and leasing--are generally conducted through subsidiaries, although firewalls are not prominent.

Securities firms perform the underwriting, brokering and dealing in corporate securities markets. They also have extensive dealings in government securities, commercial paper, and options and futures contracts. Except in their offshore affiliates, securities firms are not permitted to engage in commercial or trust banking and have only a limited ability to deal in foreign exchange. Four firms dominate the domestic capital markets and are developing international orientations as well.

A number of the city banks and long-term credit banks have established a strong global presence. In the United States, Japanese banks are major providers of wholesale and middle market credit. Although there are about 80 foreign banks and almost 50 foreign securities firms represented in Japan, their market share in most financial services has remained small.

2.2 *Regulatory supervision and protections in marketplace*

The Ministry of Finance (MOF) has primary regulatory authority over all financial firms. The MOF's Securities Bureau supervises securities firms, including their offshore banking affiliates, and government bond dealers, including those affiliated with banks. The MOF's Banking Bureau is the primary regulator for banks and their offshore securities affiliates.

The Bank of Japan (BOJ), the central bank, requires all accountholders to file periodic financial reports and to submit to on-site examinations in connection with their account relationships. In addition to depository institutions, some securities firms and financial institutions for small business can also maintain accounts at the BOJ. These institutions may also have direct access to the payments system and, to a limited extent, the discount window. While non-bank access to the discount window is permitted by law, it is rarely used in practice.

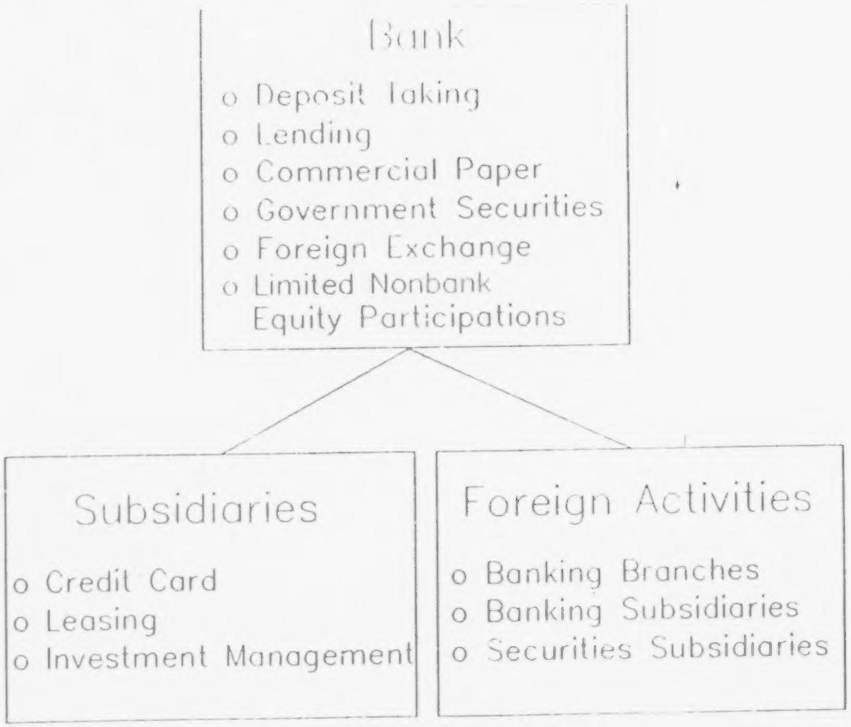
There are three other important supervisors of financial firms. The MOF's International Finance Bureau has some oversight responsibility for the foreign activities of Japanese financial firms. The Insurance

Department of the Banking Bureau supervises insurance companies and the deposit insurance program. The Ministry of Posts and Telecommunications regulates the Postal Savings System which manages a large portion of household savings and directs those savings primarily into government securities.

The Deposit Insurance Corporation was established in 1971. The Corporation's Management Committee, which includes the Deputy Governor of the BOJ, makes determinations affecting the payment of insurance claims and sets insurance premiums, subject to the approval of the Ministry of Finance. If a member institution becomes insolvent, the insurance fund will reimburse depositors up to ten million yen (about $68,000). If another financial institution is willing to take over the assets and obligations of an insolvent member, the Fund is authorized to make funds available to facilitate the rescue.

The MOF is currently considering major financial system reforms. The Banking Bureau has recently circulated for public comment five alternative proposals for restructuring financial firms (see attached chart). The different schemes include: (1) incremental broadening of powers of existing institutions; (2) authorizing banks and securities firms to establish wholly-owned subsidiaries in specified financial areas; (3) allowing financial firms to set up multi-functional subsidiaries; (4) creating holding companies with banking and securities subsidiaries; and (5) establishing a universal banking system. The Securities Bureau will soon release the results of its own study of these same issues.

JAPANESE COMMERCIAL BANKS



Bank

- o Deposit Taking
- o Lending
- o Commercial Paper
- o Government Securities
- o Foreign Exchange
- o Limited Nonbank Equity Participations

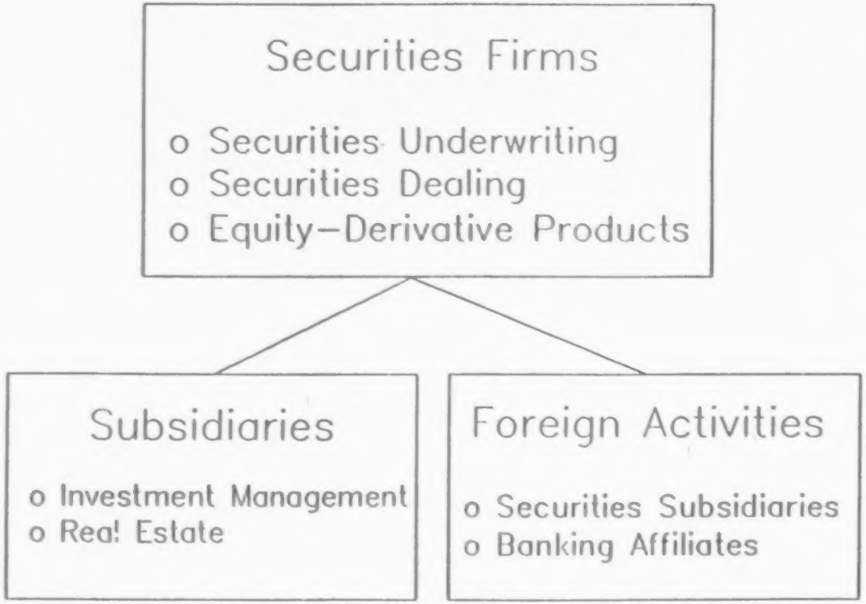
Subsidiaries

- o Credit Card
- o Leasing
- o Investment Management

Foreign Activities

- o Banking Branches
- o Banking Subsidiaries
- o Securities Subsidiaries

JAPANESE SECURITIES FIRMS



Securities Firms

- o Securities Underwriting
- o Securities Dealing
- o Equity–Derivative Products

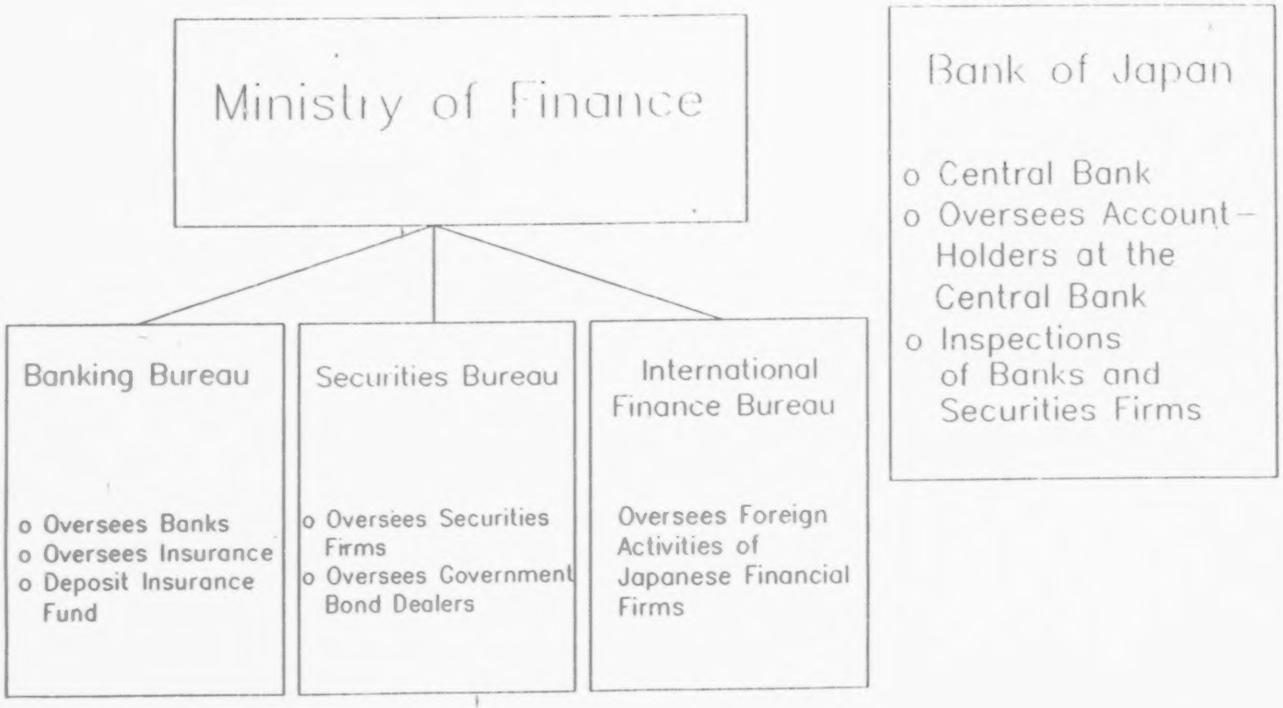
Subsidiaries

- o Investment Management
- o Real Estate

Foreign Activities

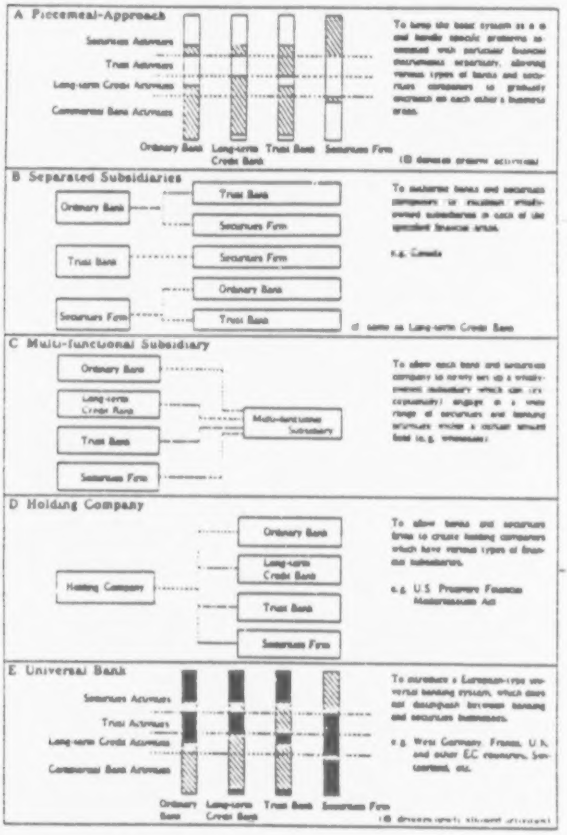
- o Securities Subsidiaries
- o Banking Affiliates

JAPANESE REGULATORY STRUCTURE


Ministry of Finance
Banking Bureau
o Overseas Banks
o Oversees Insurance
o Deposit Insurance Fund
Securities Bureau
o Oversees Securities Firms
o Oversees Government Bond Dealers
International Finance Bureau
Oversees Foreign Activities of Japanese Financial Firms
Bank of Japan
o Central Bank
o Oversees Account-Holders at the Central Bank
o Inspections of Banks and Securities Firms

Attachment

Alternative Japanese Financial Structures: Five Proposals Put Forward by the MOF Banking Bureau


A Piecemeal-Approach
Securities Activities
Trust Activities
Long-term Credit Activities
Commercial Bank Activities
Ordinary Bank
Long-term Credit Bank
Trust Bank
Securities Firm
B Separated Subsidiaries
Ordinary Bank
Trust Bank
Securities Firm
Trust Bank
Securities Firm
Securities Firm
Ordinary Bank
Trust Bank
e.g. Canada
C Multi-functional Subsidiary
Ordinary Bank
Long-term Credit Bank
Trust Bank
Securities Firm
Multi-functional Subsidiary
D Holding Company
Holding Company
Ordinary Bank
Long-term Credit Bank
Trust Bank
Securities Firm
e.g. U.S. Proposed Financial Modernization Act
E Universal Bank
Securities Activities
Trust Activities
Long-term Credit Activities
Commercial Bank Activities
Ordinary Bank
Long-term Credit Bank
Trust Bank
Securities Firm
e.g. West Germany, France, U.K. and other EC countries, Switzerland, etc.

Source: Second Financial System Committee of the Financial System Research Council, **On a New Japanese Financial System: Interim Report**, May, 1989.

3. United Kingdom: Emerging Integration

3.1 Services provided by major financial institutions

The UK financial system has no formal barriers preventing financial firms from engaging in diverse services such as banking, securities underwriting and dealing, investment management, and commerce. Historical evolution, however, has led to a financial system with specialized institutions engaged in discrete activities. Since the mid 1980s, financial service integration has been increasing.

Commercial banks are responsible for the majority of the retail banking activity in the United Kingdom. A dozen of so of these banks, including one foreign bank, are known as clearing banks because they are lead participants in various payments clearing organizations that settle across the books of the Band of England (BOE). The big four clearing banks--Barclays, National Westminster, Lloyds and Midland--dominate retail banking activity and have a global orientation. In recent years, these firms have expanded into merchant banking, foreign exchange dealing, leasing, factoring, insurance brokerage, investment advising, securities brokerage and market-making, largely through acquisitions.

Merchant banks, like commercial banks, can accept deposits and make loans, but they are typically wholesale-oriented and rarely have branches. They focus on investment banking activities such as corporate finance, advising on mergers and acquisitions, institutional investment management, and securities underwriting and dealing. Securities firms in the United Kingdom engage in most of the same activities as merchant banks with the exception of deposit-taking. The majority of securities firms in the United Kingdom are subsidiaries of foreign investment banks. Building societies, finance companies, and trustee savings banks are other important financial institutions that provide consumer and commercial credit to specific regions or groups of firms.

The United Kingdom does not have any explicit legal barriers between investment and commercial banking, nor between banking and commerce. In practice, however, combinations of banking and commercial firms are not common. An expansion of services by banks achieved through acquisition is generally permitted but is subject to the review of the BOE. The large commercial banks frequently have merchant banking subsidiaries, but merchant banks do not generally have commercial bank subsidiaries.

Life insurance and banking have become increasingly integrated in the United Kingdom. Lloyds Bank PLC, the third largest bank in the United Kingdom, acquired control in 1988 of a large insurer, Abbey Life Ltd. Halifax Building Society, the largest thrift, has recently proposed to join with another major insurer, Standard Life Ltd. Commercial banks and merchant banks have historically not been involved in other, higher risk, insurance activities.

The UK securities market underwent a major restructuring in the late 1980s following a series of stock market reforms in 1986 and the implementation of the Financial Services Act of 1987. The thrust of these reforms was (1) to deregulate securities commissions, (2) to relax the restrictions on ownership for securities brokers and dealers, and (3) to institute a self-regulatory regime of investor protection. At the same time, many commercial banks, merchant banks, and foreign financial firms expanded their presence in the UK securities markets by acquiring brokers and dealers. Some US firms have recently scaled back their operations in the United Kingdom because of poor earnings.

3.2 *Regulatory supervision and protections in marketplace*

The United Kingdom has a functional supervision system that is implemented on a more informal and flexible basis than in the United States. The Bank of England (BOE) has very broad supervisory powers over banking, government securities, and wholesale markets--foreign exchange, large deposits, bullion, and forward and options contracts not traded on an exchange. When financial firms plan a major acquisition or expansion into new areas of service, they seek on an informal basis the approval of the BOE.

UK banks are not required to adopt holding company structures, the main exception being that government securities dealings must be performed in separately capitalized subsidiaries. Many banks, however, choose to perform certain activities through subsidiaries. Despite this separation of activities, bank solvency and liquidity tend to be assessed on a consolidated basis.

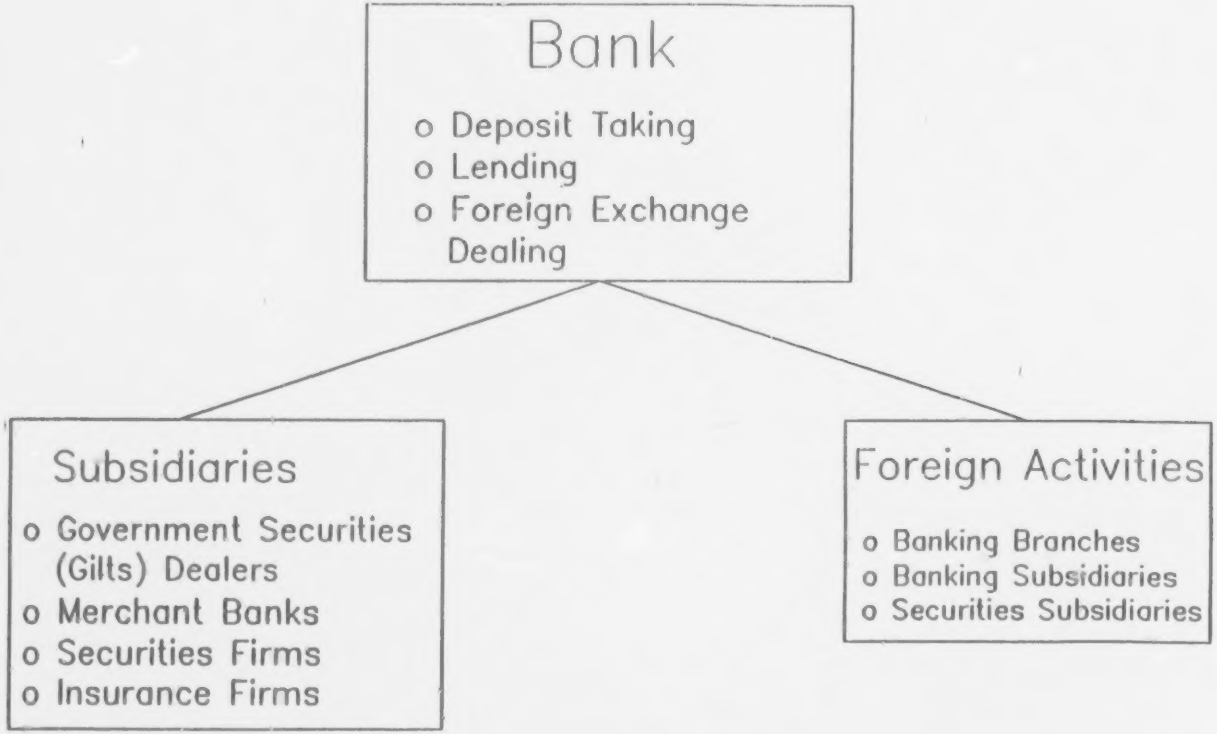
The Securities and Investment Board (SIB), under the auspices of the Department of Trade and Industry, oversees all other securities activities having to do with the sale and management of investments. The SIB also supervises various self-regulatory organizations that set rules of conduct for securities firms, investment managers, broker/dealers for futures contracts, life insurance companies, and others.

The insurance industry is also regulated by the Department of Trade and Industry.

Investment activities, such as retail securities brokerage, are regulated by the SIB. The BOE is primarily concerned with prudential supervision, and the SIB is primarily concerned with investor protection and codes of conduct. Recent Memoranda of Understanding between the BOE and SIB effectively recognize the BOE as the lead regulator in most cases in which their authorities overlap.

The United Kingdom established a deposit insurance program in 1979. The Deposit Insurance Fund is administered by a board of three high-level BOE officials and several other members appointed by the Governor of the BOE. The insurance covers only 75 percent of the first 20,000 pounds (about $34,000) of an account. Premiums are assessed as needed to replenish the fund. The administrators of the Fund do not have any independent, bank supervision role.

UNITED KINGDOM COMMERCIAL BANKS



Bank

- Deposit Taking
- Lending
- Foreign Exchange Dealing

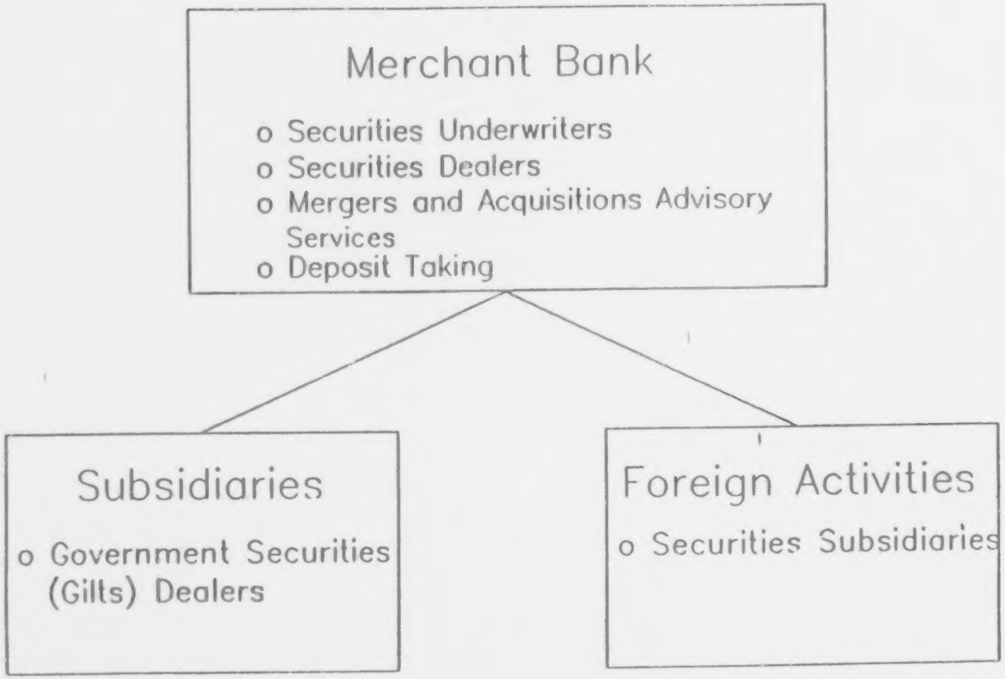
Subsidiaries

- Government Securities (Gilts) Dealers
- Merchant Banks
- Securities Firms
- Insurance Firms

Foreign Activities

- Banking Branches
- Banking Subsidiaries
- Securities Subsidiaries

UNITED KINGDOM MERCHANT BANKS



Merchant Bank

o Securities Underwriters
o Securities Dealers
o Mergers and Acquisitions Advisory Services
o Deposit Taking

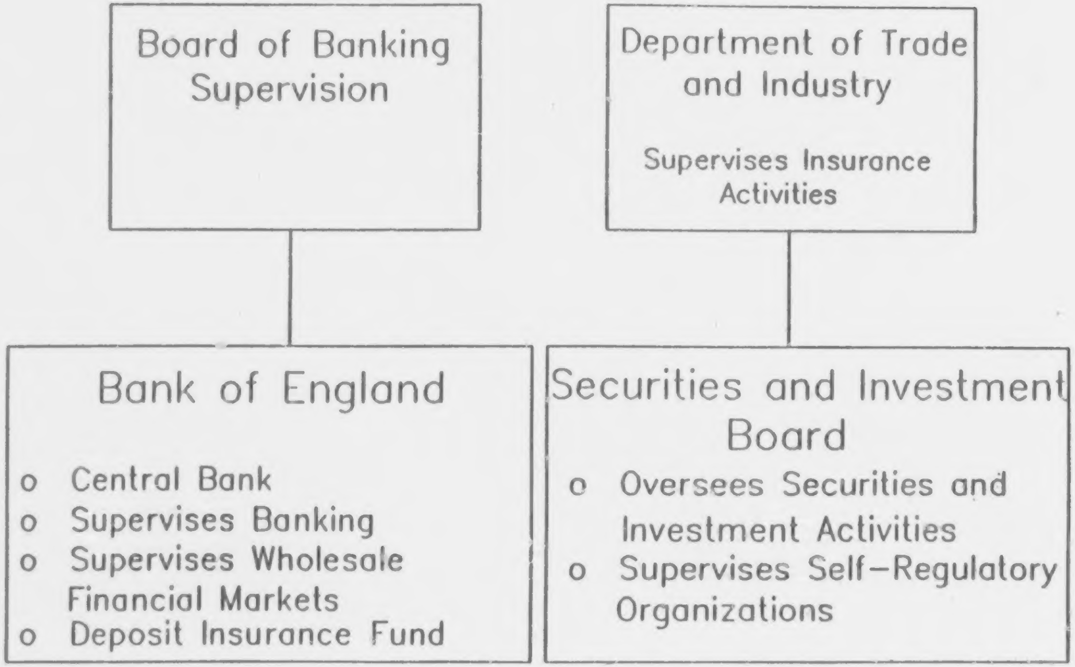
Subsidiaries

o Government Securities (Gilts) Dealers

Foreign Activities

o Securities Subsidiaries

UK REGULATORY STRUCTURE : FUNCTIONAL SUPERVISION



Board of Banking Supervision

Department of Trade and Industry

Supervises Insurance Activities

Bank of England

- Central Bank
- Supervises Banking
- Supervises Wholesale Financial Markets
- Deposit Insurance Fund

Securities and Investment Board

- Oversees Securities and Investment Activities
- Supervises Self-Regulatory Organizations

4. The European Community: The Second Banking Directive

The Second Banking Directive was approved unanimously by the European Community (EC) Council of Ministers in December 1989. The Directive permits banks, after 1992, to operate throughout the EC with a single banking license issued in a "home" EC country. Licensed banks will be able to establish branches and to provide banking services in "host" EC countries.

If permitted by their home country regulations, banks could conduct the following activities in host countries:

1. Acceptance of deposits and other repayable funds from the public;
2. Lending (including consumer credit, mortgage credit, factoring, financing of commercial transactions)
3. Financial leasing;
4. Money transmission services;
5. Issuing and administering means of payment (e.g., credit cards, travellers' checks and bankers' drafts)
6. Guarantees and commitments;
7. Trading for own account or for accounts of customers in:
   a. money market instruments,
   b. foreign exchange,
   c. financial futures and options,
   d. exchange and interest rate instruments, and
   e. transferable securities;
8. Participation in share issues and the provision of services related to such issues;
9. Advisory services regarding mergers, acquisitions and capital structure;
10. Money brokering;
11. Portfolio management and advice;
12. Safekeeping and administration of securities;
13. Credit reference services; and
14. Safe custody services.

The Directive provides for the mutual recognition of the supervisory standards of other EC-member countries, subject to certain minimum standards. The home country authorities will be responsible for the supervision of the parent company and all branches, regardless of their locations within the Community.

The Directive also discusses the treatment of banks from non-EC countries. Those banks already licensed in the Community will be permitted to provide the same services as EC banks. However, the Commission's assessment of the treatment of EC financial institutions by a non-EC country may determine whether banks from that country can obtain new licenses.

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Appendix II

Dealing with Financial Institutions in Distress:

The Experience of Four Countries

Overview

How have the authorities in other countries dealt with distress in their financial systems? To gain insight into this question, the staff of the Federal Reserve Bank of New York put together profiles of six episodes in four countries. The staff relied almost exclusively on published accounts, including newspaper reports. One episode took place in Japan, two in the United Kingdom, two in Germany, and one in Canada.

In most of the cases, the authorities came quickly to the rescue of troubled institutions, mobilizing public and private resources. Decisions to intervene did not seem to depend so much on an ailing institution's size as on a perceived threat that problems might otherwise spread. Even in allowing some institutions to close, the authorities were most reluctant to tolerate a disorderly collapse, often going to great lengths to avoid a disruption in the financial system. In the case of banks, preserving confidence in the system usually meant providing enough liquidity to protect depositors and to provide the time until the situation could be fully assessed and an orderly resolution of the crisis put in place.

In rough chronological order, the following summarizes the events in the four countries:

Japan - In 1965, the Bank of Japan helped prevent the collapse of Yamaichi Securities, one of the four big securities firms in the country. After stock market losses had impaired the firm's capital and customers had withdrawn liquidity, the Bank of Japan, in consultation with the Ministry of Finance, assembled a rescue plan which included the provision of credit by the Bank on a largely unsecured basis. Yamaichi eventually recovered fully, repaying the loans over four years.

The United Kingdom - In 1973, the Bank of England led the U.K. clearing banks in providing liquidity to keep open a number of secondary banks, which were the smaller, unregulated banks in the country. The distressed banks' problems stemmed from a mix of assets and liabilities that had left them vulnerable to rising interest rates. Some of the secondary banks were subsequently allowed to fail, but the failures were orderly and caused little disruption in credit markets. The operation served to permit all "outside" depositors to withdraw their funds without loss but ultimately inflicted losses on some shareholder depositors. The Bank of England and the clearing banks also incurred financial losses.

In 1984, the Bank of England assumed ownership of Johnson Matthey, a bank active as a London market maker in gold bullion. A concentration of bad loans had undermined the bank's viability. At some expense, the Bank of England nursed the troubled bank to partial health and then sold it to an Australian bank.

Germany - In 1974, the West German authorities abruptly closed Herstatt, a medium-sized bank. The bank had rendered itself insolvent by taking losing positions in foreign exchange. Some large depositors lost money, and the international payments system was disrupted. In 1983, the Germans took a different strategy when the Bundesbank helped persuade other German banks to keep afloat Schröder, Munchmeyer, Hengst and Co., a medium-sized bank, until it could be sold to another bank.

Canada - In 1985, the Bank of Canada pooled resources from the six big Canadian banks and the public sector to provide liquidity to a number of relatively small western Canadian banks. Later when it became clear that two of the distressed banks were insolvent and that confidence in the system had been stabilized, the two banks were closed, but depositors were, in all cases, kept whole.

1. Japan: The Rescue of Yamaichi in 1965

In Japan, the end of a stock market boom in 1961 exposed a securities industry that had grown by relying heavily on leverage. During the three-year boom that started in 1958, the country's securities houses invested heavily in stocks, often using borrowed funds. Then in July 1961, the market ran out of steam, and over the next three years the securities houses watched with dismay as stock prices fell 33 percent. Yamaichi Securities, one of the four big houses, suffered the worst losses.

In May 1965, concerns about wider repercussions apparently forced the Japanese authorities to help save Yamaichi from collapse. For the first time since the 1930s, the Bank of Japan offered unsecured loans to a private financial firm. The central bank eventually provided Yamaichi a total of ¥28 billion, equivalent to about $78 million at the time, the bulk of which was unsecured. Yamaichi repaid the loans over four years and today remains one of the big four Japanese securities houses.

1.1 Bull and bear markets in Japan

Industrial expansion and declining interest rates powered the so-called Iwato boom of 1958-61 in Japan. The buoyant economy lifted the stock market to new highs. As stock prices rose, the securities houses achieved record growth by selling shares in investment trusts, which allowed individuals to participate in the stock market.[1] The houses themselves participated by trading actively on their own account, often financing their stock purchases by borrowing from banks, securities finance companies, and the call market where the trusts placed their liquid funds. To secure their loans, the houses commonly resorted to *unyō azukari*, a management contract by which for a fee customers let their securities be used as collateral.[2]

The stock market slump ensued in 1961 when the Japanese authorities responded to a deterioration in the country's balance of payments by squeezing credit. After reaching a peak in July 1961, stock prices started to fall. At first, the securities houses apparently tried to prop up the market by buying more stocks. In January 1964, when that initial tactic had failed,[3] the large banks and the big four houses pooled resources to form a price-support institution, the Japan Joint Securities Corporation (JJSC). Starting in December 1964, the Bank of Japan lent the new institution about ¥70 billion to buy stocks. But stock purchases by JJSC proved inadequate, its resources overwhelmed by investment trusts selling stocks and securities houses unloading inventory. In January 1965, as losses mounted, the securities industry established a second institution, the Japan Securities Holding Association (JSHA), with a ¥224 billion loan from the Bank of Japan through a securities finance company. The JSHA could not stop the price declines either, and securities firms continued to sustain enormous losses.

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[1] As the period began, investment trusts held four percent of all listed stocks. By mid-1961, the trusts held seven percent.

[2] Hence, while the source of funds was a wholesale market, the source of collateral was a retail market.

1.2 The Yamaichi rescue

For the quarter ending in September 1964, three of the big four securities houses reported huge losses. The largest loss was Yamaichi's ¥3.5 billion, and it hastened the retirement of the firm's chairman. During the boom, the firm had borrowed heavily to bet on the more speculative stocks. Thus during the slump the firm faced interest payments that exceeded its dividend income by ever increasing amounts, at a time when selling stocks to cover the difference would have meant even greater losses. For March 1965, Yamaichi reported assets of ¥101 billion and loans of ¥73 billion, including ¥31 billion to banks.

By May 1965, Yamaichi could no longer service its debt, and its main creditor banks announced a plan to reschedule the firm's interest payments. But the disclosure of Yamaichi's plight created a wave of *unyō azukari* cancellations. It has been estimated that the loss of this important source of collateral reduced the firm's holdings by ¥23 billion. The cancellations were like a bank run, and they threatened to spread to other houses.

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[3] Two shocks in 1963 defeated the tactic. In July, President Kennedy imposed a special tax on U.S. capital outflows, ending hopes of U.S. investment in Japanese stocks. In December, in response to a worsening balance of payments, the Bank of Japan raised reserve requirements.

Perhaps because of the banking system's exposure to the securities industry, the Japanese authorities intervened. On May 29, 1965, the Minister of Finance consented to let the Bank of Japan invoke Article 25 of its charter[4] and grant Yamaichi de facto access to unsecured loans. The special loans were made through the major Japanese banks, which apparently served merely as conduits, with the Bank of Japan taking on the credit risk. It was the first time that Article 25 was used for such a rescue, although during the 1931 panic the Bank of Japan had made unsecured loans under an emergency decree. Within two months, the central bank extended its support to Oi Securities, a smaller house that had also failed to meet interest payments.

The Bank of Japan eventually lent Yamaichi ¥28.2 billion and Oi ¥5.3 billion, sums which amounted to $93 million at the time. The bulk of the loans to Yamaichi were unsecured. In June 1966, a rehabilitation plan allowed Yamaichi 18 years to repay the Bank of Japan and deferred repayments to 18 other banks for three years.

The decisive official response apparently reflected an effort to avoid the critical mistakes of the 1927 panic. The first shock then was in March 1927 when the Tokyo Watanabe Bank closed. In April, the failure of a major borrower caused a run on the Bank of Taiwan, then one of the largest Japanese banks. When an enabling decree was struck down by the courts, the Bank of Japan was unable to provide unsecured credit to the besieged bank. Within a few days, the run had spread so widely that it forced many banks in Japan, Korea and Manchuria to close. Before the government finally restored calm, the Japanese banking system had lost eight percent of its deposits, and 32 banks -- including such big ones as the Fifteenth Bank, Omi Bank, and the Bank of Taiwan -- had suspended business. As a result, the Bank of Japan Law, passed in 1942, contained Article 25, which would allow the central bank to make unsecured loans in times of distress.

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[4] Article 25 of the Bank of Japan Law states: "The Bank of Japan may, with permission of the competent Minister, undertake such businesses as are necessary for the maintenance and fostering of the credit system."

1.3 Resolution

When the government announced a strongly expansionary policy in July 1965, the stock market rebounded with vigor. The crisis was over. Only 430 securities dealers reportedly survived in an industry that had been about 600 strong in 1962. Yamaichi was reorganized in September 1966. The new Yamaichi Securities Company made the last payment to the Bank of Japan ahead of schedule in September 1969 and remains today among the big four securities houses. Oi Securities, which was succeeded by Wako Securities, made its last payment to the Bank of Japan in July 1969.

An amendment to the Securities Transaction Law went into effect in October 1965. The new rules phased in a strict licensing system for securities firms, imposed stiff capital requirements, separated the broker business from the dealer business, and segregated customer accounts to prohibit *unyō azukari*. Only the seven so-called general securities companies, including Yamaichi, were allowed to combine underwriting with the other securities functions.

2. The United Kingdom: The Secondary Banking Crisis from 1973 to 1975

At the end of 1973, several secondary banks and finance houses in the United Kingdom faced growing public concern over the quality of their assets. Deposit withdrawals were heavy, and the institutions found themselves unable to roll over short-term funds purchased in the money market. Fearing a crisis of confidence, the Bank of England swiftly led a rescue operation. Unfortunately, the crisis did not abate quickly, and over the next several years, virtually the entire secondary banking sector suffered massive losses. While many of the institutions eventually failed, the failures were controlled so that they caused no disruption in the system. Deposits in general were protected, although some shareholders lost their deposits. Only significant financial support from the Bank of England and other banks prevented the crisis from spreading to and possibly inflicting damage on the rest of the banking system.

2.1 The U.K. secondary banks

The secondary banks in the United Kingdom began to emerge about 15 years before the crisis developed. They were called "secondary" or "fringe" banks because they operated outside the primary banking sector, which consisted of the clearing banks, merchant banks, and discount houses. Needing no operating licence and left largely unregulated, the secondary banks tended to operate on the fringe of banking by serving borrowers avoided by the larger, well-established banks. These secondary banks grew dramatically, largely by relying on real estate lending.

In contrast to the secondary banking market, the larger banks and finance houses were subject to a "corset" imposed by the Bank of England to restrict the amount of aggregate lending activity. As a result, these banks and finance houses tended to ration loans to safer, more conventional loan customers, leaving the riskier loans and investments to the secondary banks.

The "corset" was lifted with the Competition and Credit Control Act of 1971, which was designed to foster competition within the banking sector, including competition provided by the secondary banks. The Bank of England began to rely on short-term interest rates as an instrument of monetary policy in place of the direct credit controls of the "corset." An expansionary monetary policy during the next two years produced a boom in the real estate and stock markets and a surge in the lending and investment activities of both the traditional banks and the newer secondary banks. The secondary banks grew rapidly by expanding their balance sheets with short-term debt and risky long-term assets, a maturity structure ill-suited for a rise in interest rates.

The troubles of several secondary banks began in 1973 when the Bank of England tried to slow the economy by raising short-term interest rates. The government also introduced a stringent "Mini Budget" to tighten fiscal policy. In the following year, both the property and stock markets plummeted, wiping out a substantial portion of the asset values of the fringe banks, and depositors accelerated their withdrawal of funds.

2.2 *The first response*

To deal with what was originally perceived to be a temporary liquidity crisis, the Bank of England immediately sought several sources of financing. The clearing banks were asked to form a "Lifeboat" by pooling together funds to be lent to troubled secondary banks, with the Bank of England agreeing to participate in the syndicate by contributing ten percent of the pooled funds. Since the public was placing much of the deposits withdrawn from secondary banks into clearing banks, it was initially thought that the Lifeboat would merely entail recycling these funds back to the secondary banks. The Lifeboat ultimately supported 26 troubled secondary banks with up to £1.3 billion in loans over the next several years.

The Bank of England, in conjunction with the rest of the Lifeboat committee, also sought other sources of funding. Some of the secondary banks' largest shareholders were asked to provide additional funds, with the Bank of England sometimes adding support in the form of indemnities. In other cases, shareholders agreed to dilute their shareholdings, and banks and other creditors were pressured by the Bank of

England to forgo their right to foreclose. In addition, numerous secondary banks were supported by their own clearing banks rather than receiving support from the pooled funds of the Lifeboat. Finally, some of the secondary banks received direct assistance from the Bank of England in various forms of credit arrangements.

2.3 The crisis continues

As the crisis continued, it became apparent that the number of troubled institutions was much larger and the problems they faced were much deeper than circumstances originally suggested. While the individual secondary banks may not have been viewed by the authorities as central to the banking system, there was fear of a run on deposits on the entire system. Since the United Kingdom did not have a formal deposit insurance scheme in place, the approach taken by the Bank of England provided a high degree of comfort that depositors who were not also shareholders would not lose any of their funds -- and, in fact, they did not. Some shareholders, however, lost deposits, including the Crown Agents organization, a quasi-government institution which reportedly lost millions. Finally, after the Herstatt failure in Germany in 1974, the Bank of England was apparently sensitive to potential international spill-over effects and saw to it that the supported banks did not default on any of their Euromarket loans.

As a condition for support, most of the secondary banks and finance houses scaled down their operations considerably. The Bank of England arranged for many of the troubled banks to be merged with or acquired by healthy institutions. The Bank itself eventually acquired two major secondary banking concerns, Slater Walker Bank and the Edward Bates Group.

2.4 *Aftermath*

As a result of the secondary banking crisis, massive losses were incurred not only by the secondary banks and finance companies, but also by those that financed the rescue operations. It has been estimated that the Bank of England lost £100 million, and that the clearing banks lost £50 million from their Lifeboat participations alone.

The crisis prompted passage of the Banking Act in 1979, which substantially strengthened the Bank of England's supervisory role. Deposit-taking institutions were required to obtain from the Bank of England either official recognition as a bank or a licence to take deposits. In addition, the resources of the supervisory group within the Bank of England were significantly increased. Finally, a formal deposit insurance scheme was introduced.

3. The United Kingdom: The Johnson Matthey Affair in 1984

On October 1, 1984, the Bank of England mounted a major effort to rescue Johnson Matthey Bankers (JMB), the banking, gold bullion, and commodity trading subsidiary of the Johnson Matthey group. The problems of JMB seemed a matter of concern because the bank was one of the five officially recognized bullion dealers in the London gold market. The five dealers fixed the price of gold twice daily, ensuring a liquid market and providing an efficient mechanism for clearing gold transactions. As the supervisory authority for the gold market, the Bank of England was apparently concerned that a disruption here would trigger problems elsewhere.

In an apparent effort to contain systemic risk, the Bank of England launched a rescue operation with largely its own resources. The Bank purchased the insolvent institution for £1 and injected £100 million of its own funds to stabilize the situation. JMB's parent, Johnson Matthey PLC, made a capital contribution of £50 million, which was all it could provide at the time. The Bank also assembled an indemnity package of £150 million as a backstop against further losses. A senior Bank official was seconded to operate JMB.

3.1 Emergence of the problem

As general trading activity in the metals markets declined in the early 1980s, JMB compensated for dwindling bullion trading profits by expanding its other lines of business, particularly commercial lending. Between 1982 and 1984, JMB's assets other than gold doubled in size, while its capital grew by less than half. The loan portfolio grew from less than one-third to over four-fifths of total footings by year-end 1983.

Most of the growth in commercial lending was in trade finance and was concentrated in loans to three groups of borrowers. Not only did management apparently ignore the Bank of England's guidelines regarding loan concentration, but it also failed to implement a provisioning policy appropriate to the higher risk of the new lending activities. Ultimately a severe deterioration in asset quality led to insolvency.

Though JMB's auditors, Arthur Young McClelland Moores, rendered an unqualified opinion for the first six months of 1984, JMB was apparently already experiencing some financial difficulty. Profits had declined by nearly two-thirds due to growing loan loss provisions, slow trading in the gold market, and problems with financially pressed West African borrowers. Exposures to the two largest commercial borrowers accounted for about 115 percent of JMB's capital base, though the true size of these exposures was then apparently not known to the Bank of England. In August 1984, JMB's auditors reexamined the loan portfolio and concluded that the provisions necessary to cover identified losses would exhaust the bank's capital and could jeopardize the group as a whole.

One constraint facing the Bank of England was time. The Bank had reportedly only learned definitively of JMB's insolvency on Friday, September 28, 1984. Up to this point, discussions with JMB had been conducted in secrecy. Over the course of the weekend, however, news leaked out that one of the London bullion dealers was having problems. The Bank apparently felt it had to find a solution to JMB's problems before the start of business on Monday morning. During those two days, Bank staff worked continuously to find a suitable buyer for JMB. On Sunday night, the only feasible deal had fallen apart.

3.2 The rescue of JMB

At that point, the Bank decided to take control of JMB, apparently because of concerns for other gold dealers and the role of London as an international financial center. Had JMB been allowed to fail, the four other bullion dealers would have been forced to line up with other creditors to recover their cash and bullion deposits held at the insolvent organization. The Bank also may have worried about a wider loss of confidence in the London gold market. It was reported that several banks in the Far East had expressed reluctance to deal with the bullion dealers. If these banks had decided to "call gold" or had refused credit lines and moved to liquidate bullion balances, the London market might have been caught without an adequate supply of gold, and the market in physical gold might have migrated overnight. While the City no longer possessed a monopoly over gold trading, much of the trading was still based on London delivery, with most bullion dealers maintaining operations in London and many central banks keeping reserves with dealers there.

Finally, the Bank may have been concerned that problems in the gold market would adversely affect related markets, including the foreign exchange market and other traditional banking markets. The links between the foreign exchange market and the gold market had been strengthening as bullion dealers increased their currency trading activities. In addition, three of the four bullion dealers were also accepting houses.

Despite the precedent it might set, the Bank chose to orchestrate a rescue. By Sunday night, September 30, it was clear that a private acquisition of JMB was unlikely. Consequently, the Bank opted to purchase the insolvent institution for £1 and immediately injected £100 million of its own reserves. Johnson Matthey PLC, the parent, contributed £50 million, which was believed to be the most the company could provide and still remain viable. The parent financed its contribution by borrowing £25 million from a group of commercial banks and by raising £25 million from its largest shareholder, Charter Consolidated, which was given a larger stake in the firm.

A major component of the rescue plan was a £150 million indemnity package intended to cover subsequent losses in JMB's loan portfolio, although these losses were estimated to be as high as £250 million. To this package the Bank of England would contribute £75 million, while the rest would come from three groups: the clearing banks (£35 million), the accepting houses (£10 million), and the bullion dealers (£30 million).

Once steps had been taken to stabilize the situation, the Bank began the long process of rehabilitating JMB. The board of directors was reorganized, a new management team was installed, and new accountants were appointed. In addition, efforts were made to establish and implement appropriate policies and controls, including a provisioning policy, lending limits, and various other credit procedures. A work-out staff began to perform a comprehensive review of the loan portfolio and to deal with troubled credits.

3.3 Results

In April 1986, the Bank sold the bulk of JMB, including the bullion trading operation, the foreign exchange trading business, the treasury function, and the healthy portion of the loan portfolio, to Westpac, Australia's largest bank, for approximately £67.5 million, or roughly £17.5 million over net worth. The insurance and futures brokering businesses were sold for £5.5 million and £1.8 million, respectively. Thus the Bank recouped nearly three-fourths of its initial £100 million outlay, excluding potential costs to the indemnity package. The agreement on the indemnity package specified that once the Bank had recovered its £100 million, it would bear half the costs while the clearing banks, accepting houses, and bullion dealers would bear the other half. Hence, the final cost to the Bank will depend on how much it can recover from the troubled portion of the loan portfolio that it still holds.

Partly as a consequence of the JMB affair, three major changes in bank regulation were made. First, the "two-tiered" system, which classified all institutions as either "recognized banks" or "licensed deposit-takers," was abolished, so that the same set of rules would apply to all banking organizations. Second, banks were required to disclose exposures exceeding 10 percent of their capital to the Bank of England and were prohibited from lending more than 25 percent of their capital to one borrower. Finally, the role of auditors was enhanced and their relationship with bank regulators strengthened.

4. Germany: The Failure of Herstatt in 1974

Upon finding it insolvent, the German banking authorities abruptly closed Herstatt, a bank heavily engaged in international transactions.[5] The timing of the closure left hanging large numbers of foreign exchange payments, and the ensuing tangle took months to unravel.

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[5] Authority to close a bank in West Germany rests with the Bundesaufsîchtsamt für das Kreditwesen. The German central bank, the Bundesbank, apparently played no role in the crisis.

4.1 Risks in the global marketplace

In the new regime of floating exchange rates of the early 1970s, banks faced fresh opportunities for gains in the trading of currencies, but development of internal controls apparently lagged in some banks. It is reported that bank traders sometimes responded to unanticipated exchange-rate changes by taking further positions in the hope of recouping losses.

Herstatt was a medium-sized commercial bank in Cologne, West Germany. It was founded in 1955, and after less than 20 years, it had over 50,000 customers and assets of over DM 2 billion. In the early 1970s, Herstatt became a major player in the foreign exchange market, and the risks it took in that market led to the huge losses that precipitated its demise.

4.2 Initial stage of the Herstatt crisis

On June 26, 1974, at approximately 4:00 p.m. German time, Herstatt's banking license was revoked by the Bundesaufsíchtsamt für das Kreditwesen, and a liquidator appointed. The Bundesbank then ceased clearing for Herstatt's account.[6]

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[6] In fact, the Bundesbank was the target of litigation on charges of negligence for clearing for Herstatt during the few hours between the end of negotiations between Herstatt and the Bundesaufsîchtsamt für das Kreditwesen and the actual revocation of the bank's license. The litigation was unsuccessful on the grounds that the Bundesbank owed no particular duty to the plaintiff.

At the time of the closing, Herstatt was in the middle of completing millions of dollars of spot foreign exchange transactions that it had entered into two days earlier. Foreign currencies from counterparties all over the world had already flowed into Herstatt's coffers. However, as it was only the beginning of the business day in New York, payment from Herstatt in dollars was still pending. When Chase Manhattan, Herstatt's correspondent bank in New York, received word of the closure, it decided not to honor some $620 million in payment orders and checks drawn on the account. As a result, the banks that had paid into Herstatt accounts were denied the countervalues due in the spot transactions.

Payments problems reverberated throughout the international financial community. Banks in New York, for their own or customer accounts, would not make payments until they received confirmation that the countervalue had been received. Thus, large balances were held in accounts in New York banks and not paid out. Because CHIPS, the mechanism through which large international payments are made in New York, is a tightly linked system, the fact that some payments were not completed resulted in a chain reaction of other payments not being made. It is estimated that daily clearing dropped from the usual $60 billion to an average $36 billion over the three days after the failure.

On Monday of the following week, the New York clearing house banks instituted a special procedure designed to facilitate international payments. Under normal procedures, a payment entered into CHIPS could not be recalled by the sender. The participant would either settle all applicable obligations or, if the participant could not settle on time,[7] all payments by and to the participant would be removed from the system. The special procedure, however, now allowed the sender to recall individual payments until 10:00 the next morning. This gave banks the confidence to submit payment messages into the system but reduced the extent to which such payments could be relied upon by the receiving CHIPS participants, who had to wait until the next morning. While effective as a stopgap measure, the delay added uncertainty to the foreign exchange and Eurodollar markets.

No German bank came to the rescue of Herstatt, although a consortium of private banks provided full compensation for depositors with accounts under the equivalent of about $7,500.[8] In addition, one prominent investor in Herstatt brought resources to bear as part of the ultimate workout.

4.3 Disentangling the transactions

Recognizing the lack of clarity in several legal issues, the number of parties involved, and the complexity of the transactions, all parties actively worked toward an out-of-court settlement, although court actions to disburse Herstatt funds held in New York were also pursued. Finally, after approximately 11 months of negotiations, an agreement among all creditors was reached, and available funds were distributed. All creditors, including depositors with accounts over $7,500, lost money as a result of the failure, although we are unable to ascertain the magnitude of the losses.

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[7] In 1974, CHIPS settled on a next day basis. In 1981, CHIPS instituted same day settlement.

[8] Some sources cite the threshold figure as less than $8,000. Germany had no deposit insurance scheme in place at the time.

4.4 International bank regulation

The broad lesson of Herstatt is the importance of regulatory action that recognizes the global nature of the marketplace in which financial institutions now operate. The particular lesson is that in the failure of a bank heavily engaged in international payments, the timing of closure can be critical. Since Herstatt, regulators around the world have tried to facilitate smooth wind-downs and, in some cases, to avert failure altogether, as the Germans did in the case of Schröder, Munchmeyer, Hengst and Co. in 1983.

5. Germany: The Rescue of Schröder, Munchmeyer, Hengst and Co. in 1983

Schröder, Munchmeyer, Hengst and Co. (SMH), a West German bank, faced collapse in November 1983 when large loans extended mainly by its Luxembourg subsidiary to one company went into default. The incident occurred in the aftermath of a worldwide recession when international banks were seen as vulnerable to debt problems of less-developed countries (LDCs). Apparently at the urging of the Bundesbank, a consortium of West German banks stepped in to provide SMH with stable funding, possibly averting a collapse in interbank lending. The German Finance Ministry developed new legislation to prevent similar incidents in the future by regulating the activities of bank subsidiaries more strictly. Three months later, Lloyds Bank International bought the viable portions of the business and formed a new bank under the original name.

5.1 The loans to IBH

SMH belonged to an elite group of medium-sized universal banks and was engaged in both commercial and investment banking activities. SMH had total assets in Germany of about DM 2.2 billion ($822 million) and reported capital of DM 110 million. After consolidating its Luxembourg subsidiary, its total assets equalled approximately DM 3.3 billion.

SMH's problems arose when it was disclosed that it had lent close to DM 900 million, almost one third of its assets, to IBH Holdings. IBH had been Europe's largest construction equipment company but was then on the brink of bankruptcy. Adding to SMH's risk exposure, it also held a 9 percent equity interest in IBH.

SMH broke the spirit if not the letter of German law which limited a bank's loans to no more than 75 percent of its capital to any one borrower. Given its capital of DM 110 million, SMH could only lend DM 83 million directly to a single institution. The bank avoided this law by lending hundreds of million marks more through its Luxembourg subsidiary and a German factoring subsidiary. The details of subsidiary lending were not required to be reported to the German authorities, and the lending restrictions did not apply to subsidiary operations. Prior to this incident, nearly 40 large banks voluntarily had provided consolidated financial statements to the Federal Banking Supervisory Office. This consolidated report was limited to subsidiaries that were 100 percent owned. Even though SMH filed this report, the regulators apparently were not able to tell that the loans to various subsidiaries of IBH were related.

5.2 *The risk to interbank lending*

On the heels of a worldwide recession, financial markets were displaying a lack of confidence in the soundness of international banks, particularly in light of what appeared to be excessive LDC debt exposures. Banks had been reducing their lending to each other and were increasingly reluctant to join large loan syndications. The amount of liquid funds in international markets had been shrinking and credit lines to corporate borrowers had been reduced. Efforts were being made to keep international banks active in the Eurocredit market which had recently shown its first quarter of zero lending growth in twenty years.

It did not help that the SMH incident raised doubts about the effectiveness of European bank regulation, particularly with regard to the loosely regulated Luxembourg affiliates. While these regulatory concerns could eventually be addressed, the German authorities and the Bundesbank seemed to believe that the concern of the moment -- that lending among major European banks would halt, ultimately reducing their ability to provide credit to the nonfinancial sector -- called for an immediate response.[9]

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[9] The eagerness of the Bundesbank to resolve SMH's difficulties without closing the bank may have reflected a desire to avoid a replay of Herstatt.

5.3 The Bundesbank steps in

The Bundesbank reportedly persuaded 20 German banks to provide stable financing to SMH. The banks agreed to convert about DM 630 million of their revolving credit lines to SMH into subordinated debt in exchange for effective managerial control. The cooperatively operated deposit guarantee fund contributed a small amount of money as well. Thus, the incident caused no major market disruption, except for a small rise in interbank lending rates for Luxembourg-based medium-sized banks. There were no reports indicating that depositors lost any money.

Shortly thereafter, the German Finance Ministry proposed lending limits that would apply to banks on a consolidated basis, including partially owned subsidiaries at home and abroad. The new law was enacted two years after the SMH incident.

Three months after SMH nearly collapsed, Lloyds Bank International reportedly paid DM 100 million for parts of SMH's commercial banking business and all the investment banking business. The money was provided in the form of paid-up capital. Lloyds formed a new bank to run the business, and the bank assumed the SMH name.

6. Canada: The Western Canadian Bank Crisis in 1985

In the early 1980s, the booming oil economy in western Canada slipped into a protracted recession, causing problems for some relatively small, western Canadian banks. In March 1985, the Canadian Commercial Bank (CCB) told the Bank of Canada (BOC) that provisioning for loan losses would wipe out its capital. Although the underlying causes of CCB's troubles were largely confined to the western region and did not affect the majority of Canadian banks, Canadian officials were apparently concerned about a loss of confidence in the banking system. Thus the BOC assembled a support package, which included funds from the "Big Six"[10] commercial banks, the Canadian Deposit Insurance Corporation (CDIC), the federal government, and the province of Alberta. The BOC also agreed to make secured loans to CCB until the bank's funding base returned. Despite this support, the problems at CCB continued and spread to other depository institutions. In the end, CCB and another bank failed, although all depositors were paid in full. Two other banks were merged with larger banks. A fifth bank experienced a run on deposits but managed to restore its reputation and survive.

6.1 A crisis in the Canadian West

The Canadian Commercial Bank and Northland Bank, the two banks that failed, were middle-market lenders in western Canada. The two banks had expanded rapidly by lending freely in a booming western Canadian economy. When the economy turned down in the early 1980s, it became apparent that the two banks had lent too freely and that their loans were too concentrated in real estate and energy and in the geographic area of western Canada.

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[10] The Bank of Montreal, the Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, the National Bank of Canada, the Royal Bank of Canada, and the Toronto-Dominion Bank.

6.2 *Initial response by the Bank of Canada*

Upon being told about CCB's problems, the BOC held two meetings with senior government officials and senior officers from the "Big Six" commercial banks to decide what course of action to take. They decided on a support package of C$255 million, consisting of C$75 million from the CDIC, C$60 million from the Big Six, C$60 million from the provincial government of Alberta, and C$60 million from the federal government. The group also agreed to purchase some of CCB's problem loans, and the BOC agreed to provide additional liquidity support if CCB lost more funds.

CCB was not a large bank, and its problems were not shared by many other Canadian banks. Why then did Canadian officials decide to bail out CCB rather than liquidate it?[11] Little was known about the true condition of CCB, but if the bank was solvent, then liquidity support alone might return it to health. Canadian officials appeared concerned that a public that had not seen a bank failure since 1923 might overreact to one, particularly at a time when state-insured savings institutions in Ohio were in trouble.

6.3 *Evolution of the crisis*

As it turned out, the troubles did spread, and other western Canadian banks were affected. Northland Bank, for example, also received assistance from the Bank of Canada.[12] As time passed and the level of financing required to keep CCB and Northland afloat increased, it became more apparent that the problems at these banks were very serious and that their solvency was in question.

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[11] A merger was considered early on, but the idea was dropped after the Royal Bank of Canada said that it was not interested.

With the revelation of more problems, retail depositors lost confidence in CCB, Northland, and other small western Canadian banks and began to withdraw deposits. When the Big Six also withdrew deposits, CCB and Northland became almost totally dependent on liquidity from the Bank of Canada. Secured advances reached C$1.8 billion in August 1985, of which C$1.3 billion was to CCB and C$510 million to Northland. On September 1, 1985, the Office of the Inspector General of Banks informed the BOC that an audit of the loan portfolios of these banks indicated insolvency. The BOC withdrew its liquidity support, and the two banks were closed. No depositor lost money as a result of the closures.

In the aftermath of the two failures, it became clear that none of the C$255 million put up in the bailout plan would be recovered. In addition, the federal government covered all deposits fully, even those above the C$60,000 insurance limit.[13] Reported losses by the federal government were an estimated C$430 million on uninsured deposits in these two banks and close to C$900 million overall.

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[12] Due to previous problems, Northland had been receiving liquidity support from the Big Six since 1983. That agreement expired in June 1985, at which time Northland turned to the Bank of Canada for liquidity support.

[13] It has been suggested that this coverage was justified because officials in Ottawa had encouraged investors to keep their deposits in these two banks.

Heavy deposit withdrawals then began to plague the Montreal-based Mercantile Bank, then 24 percent-owned by Citicorp. To avoid repeating the CCB situation, the BOC arranged for liquidity support from the Big Six and searched for a merger partner. One was found, and Mercantile was merged into National Bank. In November, similar problems at the Morguard Bank in Vancouver led to its acquisition by Security Pacific Bank in California.

The fifth bank affected by the crisis, Continental Bank with headquarters in Toronto, suffered a loss of confidence when its profits fell. In this case, however, the bank's asset base was pronounced sound. The BOC and the Big Six agreed to provide liquidity while Continental worked to restore its reputation. By December, the situation at Continental had stabilized.

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APPENDIX III

THE PERFORMANCE OF INTERNATIONALLY-ACTIVE BANKS AND SECURITIES FIRMS BASED ON CONVENTIONAL COMPETITIVENESS MEASURES

Federal Reserve Bank of New York

May 1990

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I. INTRODUCTION

Financial market participants and observers alike question whether the performance of U.S. banks and securities firms has remained competitive with that of financial institutions from other industrial countries. The following analysis attempts to shed light on this issue by assessing the firm-level performances of a sample of 51 internationally-active banks and securities firms during the mid- to late-1980s. The firms are headquartered in seven countries: the United States, Canada, France, Germany, Japan, Switzerland, and the United Kingdom.

The study focuses principally on the performance of national groups in four broad categories: size, profitability, productivity, and capitalization. For each of these categories, the analysis employs standard measures to gauge success, e.g., return on assets (ROA) and return on equity (ROE) for profitability, total assets and total revenue for size. The data analyzed consist primarily of information from the financial statements of the sample firms for the period 1985 through 1988.[1] Table 1 on the following page presents a list of the 51 firms organized by country.

This analysis finds that the overall performance of the U.S. banks in the sample was in the middle range among the seven national groups of banks during the mid- to late-1980s, although a few U.S. firms showed considerable strength and must be counted among the world's leading financial players. The Japanese and U.K bank sample groups both posted performances that by a number of measures were impressive. On the basis of published financial results, the Swiss bank group also appeared strong, especially in terms of capitalization, while the performance of the German group was formidable according to a few criteria. The sample U.S. securities firms generally trailed their principal overseas analogues, the Big Four Japanese securities houses. Again, however, individual U.S. securities firms turned in results that by certain measures rivaled or surpassed those of the Japanese houses.

The limitations of this analysis should be acknowledged at the outset. Issues arise as to the quality of the data, especially regarding the comparability of cross-national data and the appropriateness of the specific measures chosen as indicators of success in each performance category. Moreover, conventional measures fail to tell the full story about competitiveness, as they do not quantify such factors as technological sophistication and financial innovation, which may be important determinants of a

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[1] Source of data: IBCA Banking Analysis Ltd., and annual reports.

TABLE 1

Banks and Securities Firms in Sample

Country:	Banks:	Total Assets 1988 (US$ millions)
CANADA:	1 Royal Bank of Canada	$82,390
	2 Canadian Imperial Bank of Commerce	71,482
	3 Bank of Montreal	61,742
	4 Bank of Nova Scotia	56,575
FRANCE:	1 Banque Nationale de Paris	196,955
	2 Credit Lyonnais	178,878
	3 Societe Generale	155,483
	4 Banque Paribas	72,534
	5 Banque Indosuez	48,156
GERMANY:	1 Deutsche Bank	167,133
	2 Dresdner Bank	127,312
	3 Commerzbank	99,634
JAPAN:	1 Dai-Ichi Kangyo Bank Ltd.	352,534
	2 Sumitomo Bank Ltd.	334,655
	3 Fuji Bank Ltd.	327,765
	4 Mitsubishi Bank Ltd.	317,762
	5 Sanwa Bank Ltd.	307,392
	6 Industrial Bank of Japan Ltd.	240,270
	7 Long-Term Credit Bank of Japan Ltd.	166,870
	8 Bank of Tokyo Ltd.	162,568
	9 Mitsubishi Trust & Banking Corp.	158,084
	10 Sumitomo Trust & Banking Co. Ltd.	139,977
	11 Mitsui Trust & Banking Co. Ltd.	134,684
SWITZERLAND:	1 Union Bank of Switzerland	109,397
	2 Swiss Bank Corp.	101,488
	3 Credit Suisse	74,970
UNITED KINGDOM:	1 Barclays PLC	189,368
	2 National Westminster Bank PLC	178,505
	3 Midland Bank PLC	100,849
	4 Lloyds Bank PLC	93,800
	5 S.G. Warburg Group PLC	21,885
	6 Kleinwort, Benson, Lonsdale PLC	16,211
UNITED STATES:	1 Citicorp	207,666
	2 Chase Manhattan Corp.	97,455
	3 BankAmerica Corp.	94,647
	4 J.P. Morgan & Co. Inc.	83,923
	5 Security Pacific Corp.	77,870
	6 Chemical Banking Corp.	67,349
	7 Manufacturers Hanover Corp.	66,710
	8 Bankers Trust New York Corp.	57,942
	9 First Chicago Corp.	44,432
Securities Firms:		
JAPAN:	1 Daiwa Securities Co., Ltd.	37,434
	2 Nomura Securities Co., Ltd.	33,386
	3 Nikko Securities Co., Ltd.	26,358
	4 Yamaichi Securities Co., Ltd.	26,191
UNITED STATES:	1 Salomon Brothers Inc.	85,256
	2 Shearson Lehman	84,800
	3 Merrill Lynch	64,400
	4 Goldman Sachs & Co.	51,300
	5 First Boston Corp.	45,227
	6 Morgan Stanley & Co.	40,050

Notes: 1) Japanese bank assets are as of March 31, 1989; Japanese securities firm assets are as of September 30, 1988.
2) Canadian assets are as of October 31, 1988.

firm's future success. Despite these limitations, however, conventional measures still tell a useful part of the story about the performance of U.S. and other financial institutions in world markets.

The discussion that immediately follows addresses the competitive performance of the 41 banks in the sample, while a shorter subsequent section considers the sample's 10 securities firms. Both the banking and securities firm discussions are arranged into four parts, each corresponding to one of the four categories of performance listed above: size, profitability, productivity, and capitalization. A concluding section recapitulates the study's general findings and reviews the limitations of the analysis.

II. Analysis of Performance Data on Banks

A. Size

The size of an internationally-active bank's operations could be an important indicator of competitive standing, since the attainment of "critical mass" and the opportunities for risk diversification afforded by size may confer important advantages in international banking. This analysis employs total assets and total revenue as two indicators of size. The principal emphasis will be on total revenue, as this measure of size captures off-balance sheet activities as well as more traditional asset-based operations.

As a corollary to these measures, this section additionally compares growth in assets and revenue of the sample institutions, since expansion of operations and market share may also signal a bank's overall success.

1. Total Assets and Asset Growth

Analysis

When the sample group is ranked by total assets expressed in nominal U.S. dollars, U.S. banks show a marked decline in their relative positions over the period 1985 through 1988. All nine U.S. banks in the sample dropped in asset ranking between 1985 and 1988. By year-end 1988, only Citicorp remained in the sample's top quartile.

The ascendance of Japanese banks according to this measure has been striking. In both 1985 and 1988, six of the sample's ten largest banks were Japanese, compared with only one in 1980. Moreover, by 1988 the scale of Japanese banks had assumed unprecedented proportions. Dai-Ichi Kangyo, with assets of $353 billion as of March 31, 1989, is approaching twice the size of the first non-Japanese bank in the sample. Similarly, the assets of four other Japanese banks in the sample exceeded $300 billion on that date.

Exchange rate movements and differing national rates of inflation only partly explain the changes in the relative sizes of the sample banks between 1985 and 1988. When the sample banks are ranked by 1988 assets adjusted for inflation and converted to dollars using 1985 exchange rates, U.S. banks still show a marked decline in their relative positions, while the rise of the Japanese banks becomes even more pronounced: on an adjusted basis, seven of the ten largest sample banks are Japanese and only one is American.

Real asset growth of the nine U.S. banks in the sample averaged 1.8% for the period 1985 through 1988. In contrast, real asset growth of the eleven Japanese sample banks averaged 12.1% annually for the period, the fastest of any national grouping. The German and Swiss bank groups also grew at relatively strong rates. (See Table 2.)

TABLE 2

Real Asset Growth
of Banks in Sample
by Country Group
1985 to 1988

	Country	*1988*	*1987*	*1986*	*1985*	*Average 1985-88*
1	*Japan*	*17.00%*	*13.93%*	*12.98%*	*4.34%*	*12.06%*
2	*Germany*	*10.48%*	*3.70%*	*3.83%*	*3.92%*	*5.48%*
3	*Switzerland*	*1.96%*	*2.33%*	*6.43%*	*3.70%*	*3.61%*
4	*United Kingdom*	*8.15%*	*-3.57%*	*9.88%*	*-4.50%*	*2.49%*
5	*France*	*14.90%*	*6.91%*	*-3.41%*	*-10.32%*	*2.02%*
6	*United States*	*-1.96%*	*-0.31%*	*2.68%*	*6.79%*	*1.80%*
7	*Canada*	*-2.14%*	*-0.18%*	*1.83%*	*5.03%*	*1.14%*

Note: Asset growth rates are calculated in home currencies.

2. Total Revenue and Revenue Growth

As suggested earlier, total revenue, defined here as gross revenue net of interest expense, may be a more accurate measure of size than total assets. The measure's usefulness in an absolute sense is somewhat weakened, however, by accounting differences that introduce inconsistencies in the definition of total revenue across countries.[2]

Analysis

The top revenue producer for the period 1985 to 1988 was Citicorp, reflecting the firm's extensive retail presence as well as its strong corporate and institutional fee-based businesses. Citicorp averaged roughly 60% more revenue than the second largest revenue producer, Barclays, and more than twice the average revenue of the first Japanese bank in the sample. The disparity between Citicorp's revenue performance and that of the generally larger Japanese banks is all the more noteworthy, considering that the revenues of the latter, when expressed in dollars, were bolstered by the strength of the yen during much of the sample period.

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[2] Furthermore, total revenue as defined in this analysis will be influenced somewhat by the capital structure of the institution. A bank using more debt to fund the same scale of activity as another bank will look weaker in terms of the measure because the figure is net of interest expense.

However, Japanese banks as a group showed the fastest real revenue growth for the period 1986 through 1988, averaging 20.3% annually. The U.S. bank group ranked a distant second, posting an average real growth rate of 7.1%. (See Table 3.)

TABLE 3

Real Total Revenue Growth
of Banks in Sample
by Country Group
1986 to 1988

	Country	*1988*	*1987*	*1986*	*Average 1986-88*
1	*Japan*	*18.28%*	*20.39%*	*22.19%*	*20.29%*
2	*United States*	*5.14%*	*5.20%*	*11.05%*	*7.13%*
3	*Canada*	*10.72%*	*2.84%*	*7.65%*	*7.07%*
4	*United Kingdom*	*6.50%*	*3.18%*	*6.70%*	*5.46%*
5	*Germany*	*7.16%*	*-3.00%*	*9.35%*	*4.51%*
6	*France*	*9.61%*	*1.12%*	*2.77%*	*4.50%*
7	*Switzerland*	*2.39%*	*1.16%*	*6.25%*	*3.27%*

Note: Total revenue is net of interest expense.

The U.S. growth rate, while falling far short of Japan's, is nevertheless significant in light of the generally slow real asset growth of the U.S. bank sample from 1986 to 1988. This divergence may reflect the tremendous expansion of the U.S. group's off-balance sheet and fee-based businesses, expansion that has taken place partly as a response to traditional leverage-based capital requirements, but more importantly in response to the relative decline in the importance of traditional intermediation activities in major U.S. banks' relationships with the business sector.

B. Profitability

Profitability, particularly over the long-term, is arguably the ultimate gauge of firm performance. This analysis focuses on return on assets (ROA) and return on equity (ROE).

Before proceeding, it must be stressed that accounting and data problems are particularly acute with regard to profitability figures. For example, in the case of the U.S. bank sample group, special provisions made against less-developed-country (LDC) loans in 1987 significantly weaken reported profitability. To a lesser extent, special LDC provisions also adversely affect the 1987 profitability figures for banks in other countries, notably the United Kingdom and Canada. Although it must be recognized that losses on LDC loans are in fact real losses, the "core" profitability of U.S. institutions, in particular, is surely stronger than indicated by the numbers for the period under study.

1. ROA

Just as total assets have traditionally served as a good proxy for the size and scope of a bank's activities, the ratio of net income to those assets has traditionally provided a fairly reliable indicator of profitability, particularly for a bank engaged primarily in conventional asset-generating activities. However, because of both the dramatic increase in most large international banks' off-balance sheet activities and the increasing tendency of many banks to sell off pools of assets soon after their creation, ROA is generally a less reliable measure of bank profitability today than ten years ago. Note that ROA figures in the following analysis are adjusted for national rates of inflation.

Analysis

During the 1985-88 sample period, the U.S. banks as a group performed slightly below the sample mean, achieving an average annual real ROA of 0.22%. Average ROA in the case of the U.S. bank sample during this period is distorted, however, by two factors: 1) the LDC provisions noted above, and 2) the protracted losses experienced by BankAmerica during 1985-87, from which it has since recovered. Thus, the performance of the U.S. bank group, excluding BankAmerica, for the years 1985 and 1986 probably gives a better indication of the "core" ROA of the U.S. bank sample. Looked at in this light, the average real ROA of the sample U.S. banks was about 50 basis points for that two-year period. (See page 8 below for a further discussion of the U.S. group's real ROA performance in 1985 and 1986.)

The British, Swiss, and Japanese bank groups posted the strongest ROA performances, attaining average real ROAs of 0.34%, 0.32%, and 0.29%, respectively. (See Table 4.)

TABLE 4

Real Return on Assets
of Banks in Sample
by Country Group
1985 to 1988

Country	*1988*	*1987*	*1986*	*1985*	*Average 1985-88*
1 United Kingdom	*0.58%*	*-0.22%*	*0.68%*	*0.32%*	*0.34%*
2 Switzerland	*0.30%*	*0.33%*	*0.30%*	*0.34%*	*0.32%*
3 Japan	*0.39%*	*0.35%*	*0.23%*	*0.19%*	*0.29%*
4 Germany	*0.27%*	*0.18%*	*0.24%*	*0.26%*	*0.24%*
5 United States	*0.90%*	*-0.76%*	*0.39%*	*0.34%*	*0.22%*
6 Canada	*0.53%*	*-0.40%*	*0.35%*	*0.36%*	*0.21%*
7 France	*0.23%*	*0.26%*	*0.22%*	*0.11%*	*0.20%*

Notes:
1) *ROA figures are adjusted for national rates of inflation.*
2) *Excluding BankAmerica Corp., which incurred losses in 1985 through 1987, the U.S. sample group's average real ROA figures are: 0.93% (1988), -0.73% (1987), 0.55% (1986), 0.49% (1985), and 0.31% (average 1985-88).*

Because, as mentioned above, the special provisions made against LDC loans in 1987 negatively distort the reported profitability of banks from the United States, the United Kingdom, and Canada during the sample period, it may be best to focus on their 1985 and 1986 performances to get a better sense of the "core" profitability of these institutions. For the period 1985-86, the U.S. group's average real ROA ranked second among the seven national groups (excluding BankAmerica, the U.S. group ranked first). The average real ROAs of the British and Canadian groups ranked first and third, respectively, over this two-year period.

The generally high returns of the British and Swiss banks over the 1985-88 sample period appear to reflect the strength of their domestic franchises in retail and middle-market corporate banking over the period. The relatively strong performance of the Japanese institutions over the same period appears due in part to gains realized from the sale of securities during the latter half of the sample period. In fiscal years 1987 and 1988, gains from securities sales for the group of Japanese banks are reported to have constituted on average 27% and 41%, respectively, of pre-tax income.

2. ROE

ROE, defined as the ratio of net income to average equity, measures the return on a firm's capital base, as given by the book value of equity. ROE bears a direct relationship to ROA as follows:

ROA = ROE * (Equity/Assets).

As the expression indicates, ROE is directly affected by leverage. Assuming a fixed return per unit of asset, the ROE of a firm will increase as its leverage increases. This sensitivity of ROE to leverage should be kept in mind when comparing the profitability of institutions.[3] As with ROA, the ROE figures examined here have been adjusted for national rates of inflation.

Analysis

The performance of the U.S. bank group in terms of inflation-adjusted ROE was 3.8% over the period 1985-88, ranking last among the seven national groups. (When BankAmerica is excluded from the U.S. sample, the U.S. group's real ROE for the period improves to 5.5%, placing it fifth.) The Japanese and French national groups were the strongest performers during the period according to this measure, generating real average ROEs of 12.3% and 9.3%, respectively. (See Table 5.)

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[3] ROA is also affected by leverage, but to a lesser extent than ROE. For given levels of earnings before interest expense and assets, the more leveraged the firm, the lower will be its ROA since net income will fall as interest expense rises.

TABLE 5

Real Return on Equity
of Banks in Sample
by Country Group
1985 to 1988

	Country	1988	1987	1986	1985	Average 1985-88
1	Japan	13.65%	14.64%	11.42%	9.42%	12.28%
2	France	9.75%	10.59%	10.44%	6.56%	9.34%
3	Germany	7.73%	4.92%	6.52%	7.74%	6.75%
4	United Kingdom	9.88%	-4.15%	13.56%	7.22%	6.65%
5	Switzerland	4.84%	5.41%	5.04%	5.69%	5.25%
6	Canada	10.44%	-8.75%	7.15%	7.91%	4.19%
7	United States	17.48%	-17.54%	7.33%	7.23%	3.75%

Notes: 1) ROE figures are adjusted for national rates of inflation.
2) Excluding BankAmerica Corp., which incurred losses in 1985 through 1987, the U.S. sample group's average real ROE figures are: 17.67% (1988), -16.34% (1987), 10.76% (1986), 9.82% (1985), and 5.48% (average 1985-88).

Again, because most of the U.S., U.K., and Canadian sample banks made large special LDC provisions in 1987, it may be more informative to consider these banks' ROEs for the more "normal" years of 1985 and 1986. Over this shorter period, the U.S. sample group's average real ROE ranked fourth among the seven national groups (excluding BankAmerica, the U.S. group ranked third). The British and Canadian groups ranked first and fifth, respectively, during this same two-year period.

In addition to the caveat just cited regarding special LDC provisions made in 1987, other problematic factors must be considered when interpreting the above profitability figures. First, the relatively low equity ratios of the French and Japanese banks have likely driven their high ROEs during the 1985-88 sample period. Similarly, the high equity ratios that the Swiss and U.K. bank groups maintained over the period (See Section D. on Capitalization below) may have caused their ROE performances to be understated relative to bank groups with lower equity ratios. Second, the German and Swiss bank group performances are almost certainly stronger than implied by the above figures. Institutions from both countries are known to have benefited from unreported income over the sample period.

C. **Productivity**

Productivity measures help shed light on the efficiency of a bank's operations. These measures may indicate a bank's ability to compete under changing market conditions and over the long-term. The analysis in this section employs one common gauge of productivity: total revenue/non-interest expense. Comparisons of bank performance based on this indicator should be interpreted cautiously, however, because differences in the measure may be driven by the different expense and personnel levels associated with dissimilar banking strategies (e.g., retail banking versus wholesale banking).

Analysis

For the period 1985 through 1988, the sample U.S. banks produced an average of $1.52 of revenue for each dollar of non-interest expense, a performance that fell in the middle range among the seven national groups. The top performers overall were the Japanese banks, which as a group produced an average of $1.91 of revenue per dollar of non-interest expense over this period. (See Table 6.)

TABLE 6

Total Revenue / Non-Interest Expense
of Banks in Sample
by Country Group
1985 to 1988

	Country	1988	1987	1986	1985	Average 1985-88
1	Japan	2.14	2.01	1.84	1.65	1.91
2	Canada	1.78	1.73	1.74	1.73	1.74
3	United States	1.54	1.46	1.53	1.54	1.52
4	United Kingdom	1.52	1.51	1.53	1.52	1.52
5	France	1.45	1.42	1.54	1.50	1.48
6	Germany	1.38	1.38	1.54	1.52	1.45
7	Switzerland	1.34	1.36	1.39	1.40	1.37

Note: Total revenue is net of interest expense.

D. Capitalization

From a competitive standpoint, the importance of a bank's capital base stems from its role both in absorbing losses and in funding future expansion. All other things equal, a better capitalized bank should have an advantage over more poorly capitalized competitors. This section uses the ratio of shareholders' equity to total assets to assess capitalization.

Subsequently, the analysis focuses on the ratio of market capitalization to earnings, or the price-earnings multiple. This ratio should provide a sense of the market's evaluation of banks' future prospects and also help identify banks that may possess cost advantages in raising equity capital.

1. Shareholders' Equity Ratio

The shareholders' equity ratio provides a good measure of the strength of a bank's highest-quality capital base (i.e., common and perpetual preferred stock, plus retained earnings). The measure is reasonably comparable across countries; however, it relies on total assets as the proxy for bank size, thus ignoring off-balance sheet activities. Another major limitation of the measure is that it does not include other capital components and fails to consider hidden reserves.

Analysis

When measured by the ratio of shareholders' equity to total assets, the U.S. banks as a group are among the most highly capitalized institutions in the sample. At year-end 1988, the U.S. group had an average equity ratio of 5.2%, behind only the Swiss and U.K. national groups, which posted average equity ratios of 6.1% and 5.9%, respectively. The shareholders' equity ratios of the Canadian banks, which averaged 5.1% at fiscal year-end 1988, were also relatively strong. (See Table 7.)

TABLE 7

Shareholders' Equity Ratio of Banks in Sample by Country Group 1985 to 1988

	Country	*1988*	*1987*	*1986*	*1985*	*Average 1985-88*
1	*Switzerland*	*6.14%*	*6.13%*	*6.02%*	*5.95%*	*6.06%*
2	*United Kingdom*	*5.85%*	*5.36%*	*4.97%*	*4.48%*	*5.17%*
3	*United States*	*5.16%*	*4.36%*	*4.97%*	*4.77%*	*4.81%*
4	*Canada*	*5.08%*	*4.61%*	*4.84%*	*4.55%*	*4.77%*
5	*Germany*	*3.53%*	*3.60%*	*3.63%*	*3.38%*	*3.53%*
6	*Japan*	*2.82%*	*2.42%*	*2.01%*	*2.03%*	*2.32%*
7	*France*	*2.36%*	*2.43%*	*2.15%*	*1.62%*	*2.14%*

Note: Shareholders' Equity Ratio = shareholders' equity / total assets.

The Swiss and German banks are almost certainly better capitalized than their shareholders' equity ratios indicate, given their extensive hidden reserves, which represent an additional and important source of financial strength. Some consideration in this regard must also be given to the unrealized securities gains of the Japanese banks.

2. Ratio of Market Capitalization to Earnings or P/E Multiple

Market capitalization, defined as a firm's current share price times shares outstanding, should represent the market's assessment of a firm's net worth. When market capitalization is expressed as a ratio to earnings, the firm's price-earnings (p/e) multiple is obtained. High p/e multiples usually indicate that earnings are expected to grow quickly and/or that the risk-adjusted return on equity required by investors is low. Lower required returns on equity allow banks to price more aggressively and should enable them to increase market share relative to institutions whose investors require higher returns. Thus, a high p/e multiple very often indicates a competitive advantage.

Analysis

For the period 1985-88, the Japanese bank group produced an extraordinarily high average p/e multiple of 51, more than double the Swiss bank group's average of 22, which ranked second. With an average p/e ratio of 19, the German bank group placed a strong third among the seven national groups, while the U.S. and Canadian sample banks each produced average ratios of 8. The average p/e multiple for the U.K. bank group was 6.[4] (Because the shares of the French sample banks are largely government-owned and in general do not trade publicly, an average p/e ratio could not be calculated for the French group.)

In actuality, the advantage enjoyed by the Japanese, Swiss, and German bank groups may be much less pronounced than suggested by the above figures. It is widely believed that the reported earnings of banks from these countries understate actual earnings, resulting in an overstatement of their p/e ratios relative to the p/e ratios of other institutions.

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[4] Average p/e multiples for the U.S., U.K., and Canadian banks are based on 1985 and 1986 results only, as their 1987 and 1988 multiples are distorted by the impact on earnings of special LDC provisions made in 1987 and related tax benefits.

III. Analysis of Performance Data on Securities Firms

The 51-institution sample includes ten securities firms: six from the United States and four from Japan. Securities firms from the United Kingdom were excluded from this analysis, in part because many of them are subsidiaries of larger U.K. and foreign banks, and often are not managed as independent entities.[5] The following analysis of the balance sheets and income statements of the sample firms in most instances covers the period 1985 through 1988. Because of the unavailability of public data for one of the U.S. firms, much of the discussion focuses on only nine institutions.

In summary, the performance of the Big Four Japanese securities houses during the sample period was stronger on average than that of the sample U.S. securities firms across most measures employed in the analysis. Although some U.S. firms compared favorably to the Japanese houses in terms of selected measures, the four Japanese securities firms generally appeared faster growing, more profitable, more productive, and better capitalized than the U.S. sample group. Still, individual U.S. securities firms turned in results that by certain measures rivaled or surpassed those of the Japanese houses.

As a caveat to this discussion, asset-based measures such as total assets, asset growth rates, and ROA are not ideal indicators of a securities firm's performance. The weakness of these measures stems in part from the fact that a large portion of a typical securities firm's business does not involve the generation or holding of assets. In addition, differences between Japanese and U.S. securities firms in terms of their business lines and balance sheet structures detract from the value of these measures. A second caveat concerns the fact that the fiscal years for the U.S. and Japanese firms do not coincide. The U.S. securities firms operate on fiscal years ending December 31, while fiscal years for the Big Four Japanese securities houses have ended on September 30 (before changing to a March 31 fiscal year in 1989). A major result of this discrepancy is that the immediate aftermath of the October 1987 stock market crash is recorded in fiscal 1987 for the U.S. firms, but in fiscal 1988 for the Japanese firms.

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[5] Two independent U.K. merchant banks, which can engage in traditional commercial banking in addition to their investment banking and trading businesses, were included in the bank sample as a matter of convenience.

A. Size

1. Total Assets and Asset Growth

Important differences in Japanese and U.S. accounting practices result in a relative understatement of the asset sizes of the Japanese firms, and render comparisons between them and U.S. securities firms based on reported balance sheet numbers misleading. In order to make the U.S. and Japanese figures more comparable, the assets of the sample Japanese securities firms have been adjusted to reflect: 1) repurchase and resale agreements, known as "Gensaki" transactions, and 2) the market value of all assets, including the market value of minority holdings.[6]

Analysis

When assets of the Japanese firms are measured on an adjusted basis as just described, the two national groups are roughly comparable in terms of asset size. The sample group's largest firms were Nomura and Salomon Brothers, which held assets of $93 billion and $85 billion, respectively, at fiscal year-end 1988. In terms of real asset growth, however, the four Japanese firms clearly dominated the securities firm sample. Assets of the Japanese group grew an average of 42.2% annually over the period 1986 through 1988, while assets of the U.S. sample group grew an average of 8.3% per year.

2. Total Revenue and Revenue Growth

Analysis

In general, neither country group dominated the sample based on revenue generation. The sample group's top revenue producers were Merrill Lynch and Nomura, which respectively averaged $5.6 billion and $5.2 billion in revenue per year (net of interest expense) over the period 1985 through 1988. However, revenue growth rates of the Japanese sample were generally higher than those of the U.S. group. The Japanese houses averaged a real revenue growth rate of 20.3% compared to the U.S. average of 15.6% over the period 1986 through 1988.

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[6] Contrary to the practice of their American counterparts, Japanese securities houses do not report on their balance sheets all repurchase and resale agreements. Secondly, asset figures of the Japanese securities houses are further biased downward because the firms generally report their assets at the lower of either cost or market value. U.S. securities firms, in contrast, report almost all of their assets at market value.

B. Profitability

1. ROA

Analysis

As a group, the sample Japanese securities firms produced an average real ROA of 2.06% for the period 1985 through 1988, versus the U.S. group's 0.39%. The Japanese result appears largely driven by the strong domestic earnings bases of the four Japanese sample firms over the period, which can be attributed in part to their ability to charge fixed commissions as well as to their dominant combined market share within Japan.[7] The U.S. result may partly reflect the business practice of many U.S. securities firms to pursue low-risk, low-margin activities such as reverse repurchase transactions. (See Table 8.)

TABLE 8

Real Return on Assets
of Securities Firms in Sample
by Country Group
1985 to 1988

Country	*1988*	*1987*	*1986*	*1985*	*Average 1985-88*
Japan	*1.48%*	*2.78%*	*1.94%*	*2.04%*	*2.06%*
United States	*0.31%*	*0.23%*	*0.62%*	*0.41%*	*0.39%*

Note: ROA figures are adjusted for national rates of inflation.

2. ROE

Analysis

Equity returns for the sample Japanese securities firms tended to be substantially higher than those of the U.S. firms over the period 1985 through 1988. (An exception to this general rule is Morgan Stanley, which achieved a real ROE of 28.0% over the period.) On average, the real ROE of the four Japanese securities houses was roughly twice that of the U.S. sample group. (See Table 9.)

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[7] Domestic earnings are reported to have provided over 80% of the income of the Big Four Japanese securities houses.

Table 9

Real Return on Equity
of Securities Firms in Sample
by Country Group
1985 to 1988

Country	1988	1987	1986	1985	Average 1985-88
Japan	15.51%	27.65%	25.04%	16.23%	21.11%
United States	9.44%	6.07%	17.18%	12.89%	11.39%

Note: ROE figures are adjusted for national rates of inflation.

C. Productivity

Analysis

The Japanese houses clearly led the sample as measured by total revenue generated per dollar of non-interest expense. On average, the Japanese houses as a group produced a revenue/non-interest expense ratio of 2.14 for the period 1985 through 1988, versus the U.S. average of 1.20. (See Table 10.)

Table 10

Total Revenue / Non-Interest Expense
of Securities Firms in Sample
by Country Group
1985 to 1988

Country	1988	1987	1986	1985	Average 1985-88
Japan	1.93	2.34	2.37	1.92	2.14
United States	1.18	1.13	1.23	1.26	1.20

Note: Total revenue is net of interest expense.

D. Capitalization

1. Shareholders' Equity Ratio

Analysis

Throughout the period 1985 through 1988, the four Japanese firms maintained higher shareholders' equity ratios on average than their U.S. counterparts. (See Table 11.) At fiscal year-end 1988, the equity ratios of the four Japanese securities firms clustered between 10.6% and 7.8%. In contrast, the equity ratios of the U.S. sample firms ranged from 5.4% down to 2.1%. The strength of the U.S. firms' capital bases (relative to their total assets) may be greater than these figures suggest, given the practice of many of these firms, as already noted, to engage in low-risk, low-margin activities such as reverse repurchase transactions.

Table 11

Shareholders' Equity Ratio of Securities Firms in Sample by Country Group 1985 to 1988

Country	*1988*	*1987*	*1986*	*1985*	*Average 1985-88*
Japan	*9.5%*	*10.1%*	*7.8%*	*12.6%*	*10.0%*
United States	*3.3%*	*3.8%*	*3.6%*	*3.2%*	*3.5%*

Note: Shareholders' equity ratio = shareholders' equity / total assets.

2. Price-Earnings Multiple

Analysis

The Big Four Japanese securities houses exhibited much higher price-earnings multiples on average than those of the U.S. sample firms during the sample period. With an average p/e multiple of approximately 21, the Japanese houses enjoyed more than twice the U.S. average multiple of 9 over the period 1985 through 1988. At year-end 1988, the average p/e multiple of the Japanese firms, at 31, was more than three times that of the U.S. group (9).

E. Summary of Securities Firm Performance

In summary, the aggregate performance of the Big Four Japanese securities houses appeared stronger than that of the sample group of U.S. securities firms across most measures during the period under review. To be sure, no clear national pattern emerges from the data with regard to firm size as measured by total assets or revenue; similarly, the revenue growth rates were roughly comparable over the sample period. But significantly, the four Japanese securities houses generally appeared more profitable than the sample U.S. securities firms.

The Big Four Japanese securities houses also seemed better capitalized. In addition, the average price-earnings multiple of the four Japanese firms was more than twice that of the U.S. sample for the period 1985 through 1988; this could give the Japanese houses a potential competitive advantage vis-a-vis their U.S. counterparts as the two groups compete increasingly in international markets. Finally, the four Japanese houses achieved a better result in terms of the conventional measure of productivity used in this analysis: total revenue/non-interest expense.

IV. Principal Findings and Limitations of the Analysis

A. Principal Findings

This paper has sought to analyze the competitive performance of 51 internationally-active banks and securities firms headquartered in North America, Europe, and Japan during the late 1980s. Four broad categories of performance have been considered: size, profitability, productivity, and capitalization. Table 12 on the following page summarizes the results for the seven country groups considered.

Overall, the performance of the sample U.S. banks as a group was in the middle range among the seven national bank groups, although several U.S. institutions maintained relatively strong international competitive positions as evidenced by important measures such as revenue-generating capacity, ROA, and shareholders' equity ratio. The sample U.S. securities firms as a group generally did not perform as well as their principal overseas analogues, the Big Four Japanese securities houses. Again, however, individual U.S. securities firms turned in results that by certain measures rivaled or surpassed those of the Japanese houses.

The relatively strong performances of several other national groups during the sample period should be noted. The Japanese bank sample group performed well across most categories, looking especially formidable in terms of size and growth. The U.K. bank group also appeared strong according to many measures, particularly with regard to profitability. Based on reported results, the Swiss bank group turned in a relatively strong performance as well, showing notable strength in capitalization and profitability. And the German bank sample group reported strong results according to a few criteria such as growth and profitability. With regard to both the Swiss and German groups, however, a lack of transparency may camouflage further underlying strength in terms of profitability and capitalization.

B. Limitations of the Analysis

Major problems arise in performing an analysis of this kind and in interpreting the results. This section reviews these problems in order to clarify the limitations of this study.

TABLE 12

PERFORMANCE SUMMARY
OF SAMPLE BANKS AND SECURITIES FIRMS
BY COUNTRY GROUP

Banks

OVERALL PERFORMANCE	UNITED STATES	CANADA	FRANCE	GERMANY	JAPAN	SWITZERLAND	UNITED KINGDOM
SIZE							
Total Assets	1 of top 10	0 of top 10	2 of top 10	0 of top 10	6 of top 10	0 of top 10	1 of top 10
Real Asset Growth	1.8% (6)	1.1% (7)	2.0% (5)	5.5% (2)	12.1% (1)	3.6% (3)	2.5% (4)
Total Revenue	3 of top 10	0 of top 10	2 of top 10	1 of top 10	1 of top 10	0 of top 10	3 of top 10
Real Revenue Growth	7.1% (2)	7.1% (3)	4.5% (6)	4.5% (5)	20.3% (1)	3.3% (7)	5.5% (4)
PROFITABILITY							
Real Return on Assets	0.22% (5)	0.21% (6)	0.20% (7)	0.24% (4)	0.29% (3)	0.32% (2)	0.34% (1)
Real Return on Equity	3.8% (7)	4.2% (6)	9.3% (2)	6.8% (3)	12.3% (1)	5.3% (5)	6.7% (4)
PRODUCTIVITY							
Total Revenue/ Non-Interest Expense	1.52 (3)	1.74 (2)	1.48 (5)	1.45 (6)	1.91 (1)	1.37 (7)	1.52 (4)
CAPITALIZATION							
Shareholders' Equity Ratio	5.2% (3)	5.1% (4)	2.4% (7)	3.5% (5)	2.8% (6)	6.1% (1)	5.9% (2)
Price-Earnings Multiple	8 (4)	8 (5)	No Data	19 (3)	51 (1)	22 (2)	6 (6)

Securities Firms

OVERALL PERFORMANCE	UNITED STATES	JAPAN
SIZE		
Total Assets	Comparable	
Real Asset Growth	8.3%	42.2%
Total Revenue	Comparable	
Real Revenue Growth	15.6%	20.3%
PROFITABILITY		
Real Return on Assets	0.39%	2.06%
Real Return on Equity	11.4%	21.1%
PRODUCTIVITY		
Total Revenue/ Non-Interest Expense	1.20	2.14
CAPITALIZATION		
Shareholders' Equity Ratio	3.3%	9.5%
Price-Earnings Multiple	9	21

Notes: 1) Figures represent country averages for the sample period, except for the shareholders' equity ratio country averages, which are as of fiscal year-end 1988.

2) Ordinal ranking among the seven national groupings of banks appears in parentheses where appropriate.

3) Average price-earnings multiples of the U.S., Canadian, and U.K. bank groups are calculated from their 1985 and 1986 results only.

1. Problems Concerning Methodology and Data

First, differences in national financial customs and accounting standards limit the accuracy of performance comparisons based on reported data. The problem of cross-national comparability of data may be especially acute in the case of German and Swiss banks, where published results are widely believed to underrepresent the financial strength of particular firms. Accounting conventions in Japan may similarly result in an understatement of earnings for Japanese firms, and thus the actual performances of Japanese institutions may be stronger than the measures indicate.

Second, fundamental differences in the balance sheet compositions of banks and securities firms make most performance comparisons between these two groups difficult and potentially misleading. Therefore, this analysis has generally focused on banks and securities firms separately.

Third, there are problems with sample size and selection. Although the intention underlying this study has been to select a representative sample of internationally-active institutions, the sample group is not comprehensive, and hence not necessarily typical of other major financial firms.

Fourth, there are important difficulties with conventional approaches to assessing competitiveness. In the first place, one can debate the appropriate criteria for gauging performance: size, profitability, productivity, etc. Beyond this obstacle, problems arise in developing proxies to measure success in the categories selected. There will be deficiencies associated with any measure one employs. Total assets as a measure of size, for example, fails to consider off-balance sheet activities; ROE and, to a lesser extent, ROA are influenced by differing degrees of leverage across firms, etc. Moreover, most of the measures of performance employed in this analysis draw on financial statement information, which in some instances does not accurately reflect a firm's underlying financial condition.

2. Difficulties in Interpreting Findings

Additional difficulties arise in assessing the implications of the analysis for the overall competitiveness of individual firms and national groups. First, performance in the four categories selected may not tell the full story about firm-level competitiveness. Factors potentially critical to a firms' future success such as technological sophistication and innovative capacity have not been taken into account in this analysis as they generally cannot be quantified using standard measures.

Second, many institutions and country groups performed unevenly across categories. Judging overall performance based on the conflicting signals of various measures is a daunting task. The findings of this paper rely on the "weight of evidence" furnished by the measures. Clearly, a more precise understanding of the relative importance of each category would be useful in strengthening the overall assessments.

What the results suggest about future outcomes is also unclear. Past performance, especially over a short period, may not be a good gauge of future success.

Finally, it should be noted that this study's results appear to be at odds with research on firm performance in specific product markets, as well as interviews with senior strategists at several financial institutions, which suggest that U.S. banks and securities firms are among the most advanced and innovative in the world. The findings presented here should be reconciled with this additional evidence before definitive conclusions on competitiveness are drawn.

The above considerations demonstrate the need for care in interpreting the findings of this study. Although considerable effort has been expended to present a reasonably accurate picture of the performance of the seven national groupings of institutions, the underlying strengths and weaknesses of sample institutions from several countries remain somewhat unclear. Nevertheless, the analysis of firm-level performance offered here still tells a useful part of the story about the competitive position of U.S. and other financial institutions, and it remains an essential starting point for subsequent, more conceptual studies of competitiveness.

J. Andrew Spindler
Jonathan T.B. Howe
David F. Dedyo

Federal Reserve Bank of New York
May 1990

Appendix IV

EXTRACT FROM STATEMENT
BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK
BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
DECEMBER 10, 1987

Systemic Risk and Supervisory Policy

Mr. Chairman, I would now like to close my statement with some comments about the more general subject of systemic risks and supervisory policy.

There are, of course, many reasons why, as a matter of public policy, governments of all kinds and in all places choose to subject banking and finance to a higher degree of official supervision than is the case with most other kinds of business enterprise. Those reasons may include a menu of considerations ranging from investor and depositor protection on the one hand to concerns about misuse of economic and financial power on the other.

However, a more fundamental point lies at the heart of public policy concerns about the banking and financial system. That concern relates to the systemic risk inherent in banking and finance. By systemic risks, of course, I mean the dangers -- however small or remote they may be -- that failure or instability in one institution or in one segment of the financial markets can quickly be transmitted to other institutions or segments of the markets, thereby causing a more generalized crisis of confidence with all of its potential for instability in the financial and real sectors of the economy. Concerns about systemic risk are not new. Indeed, Adam Smith, in the Wealth of Nations, made the case for the regulation of banking by equating the responsibility of governments to regulate banking to the responsibilities of 18th century governments to insist on the construction of firewalls to protect the many from the problems of the few.

The systemic risk problem in banking and finance is, at the end of the day, what gives rise to the so-called "moral hazard" dilemma associated with supervision and regulation. By that, I mean the oft-cited dilemma public authorities face in responding to problems in the banking and financial sector. The dilemma, as you know, is that if on the one hand the authorities step in to respond to a problem, that action entails the obvious danger that it can encourage others to act irresponsibly and recklessly in the belief that they will be "bailed out." On the other hand, if the authorities do nothing, they run the risk that the problem will spread and unleash a chain reaction of other problems and failures resulting in a generalized and far more damaging situation.

It seems to me important that we have a good grasp of the issues involved with respect to systemic risk considerations for at least two reasons.

First, while it is true that the probabilities of an event with major systemic implications occurring are statistically very small, it is also true, at least in my judgment, that the nature of the operational, liquidity and credit interdependencies in our contemporary financial markets and institutions is such that the potential for such a problem should not be dismissed lightly. It is for precisely that reason that I place so much emphasis on what I affectionately call "the plumbing of the system" -- payments, clearance and settlement arrangements. These elements of the system are the transmission vehicles through which problems are likely to spread in a fashion that is rapid and difficult to control, thereby possibly taking on systemic characteristics.

Second, there is a tendency in some circles to associate systemic risk considerations and the so-called "moral hazard" dilemma only with insured deposits or depositories and, at the extreme, only with large insured depositories. In my judgment, that view is simply wrong. In 1985, the failure of a small securities firm in Florida triggered a chain of events that entailed, among other things, the Ohio and Maryland thrift crisis and came close to producing a situation that impaired the workings of the market for mortgage-backed securities. That chain of events generated headlines and lead items on the nightly news all over the world. But none of the institutions directly involved were Federally insured depositories, and none were large by most definitions. More recently, the developments in October clearly posed systemic risks, but the direct source of the problem was not with insured depositories, although the potential for the problems to affect insured depositories was clearly there.

I raise these considerations at this time because they are, in my judgment, directly relevant to the broad thrust of supervisory policy on several counts. One particularly important issue is the question of whether we should insist on at least a degree of consolidated supervision of the holding companies that own and control a family of financial subsidiaries, especially if one of those offspring is an insured depository. Both S.1886 and S.1891 contain provisions calling for varying degrees of such consolidated supervision, which I enthusiastically applaud. But a growing number of influential voices are suggesting that functional supervision of the component entities within such a financial conglomerate is adequate and, by extension, that there is no need for any consolidated supervision of the company as a whole.

I categorically disagree with this view, in part because it can become the smoke screen that would be used to permit a blending of banking and commerce; in part because it can also be used to undercut or eliminate the indispensable role that the central bank should play in the supervisory arena. But, I disagree most of all because that view collides head-on with the realities of the marketplace. The marketplace views these companies as a whole; the owners of these companies view them as a whole; so it seems to me to follow that an element of supervisory policy must focus on the company as a whole.

The holding companies of which I speak are not mere shells or corporate fictions. They are the financial and managerial nerve centers of the family of enterprises they own and control. They are the entities that raise debt and equity capital in the markets and allocate that capital among the various operating entities. Further, these holding companies raise sizeable sums of short-term working capital in the markets and allocate the proceeds to the operating entities and, in their own right, they are increasingly engaged in on- and off-balance sheet credit extension activities. Moreover, in the absence of some degree of supervision at the holding company level, the central thrust of supervisory efforts at the level of the operating units can easily be circumvented by shifting activities, as desired, to the holding company level -- something we see even now where holding companies are not supervised.

In all of these circumstances it seems to me obvious that, if the holding company -- the entity that is the point of access to capital markets -- has problems, those problems cannot help but have adverse consequences for its operating subsidiaries. Finally, at least in the case of bank holding companies, a move away from consolidated supervision would run directly counter to the grain of international developments and practices. Stated in its most graphic terms, is this the time to even consider a banking and financial system with a large unsupervised financial black hole into which any or all activities can be shifted at the convenience or whim of management in order, among other things, to escape supervisory oversight? Only the Congress can answer that question, as well as the more fundamental questions related to the banking commerce debate. For my part, I continue to believe that banking and commerce should be kept separate and that bank and financial holding companies should be subject to a degree of consolidated supervision.

In saying this, I am not suggesting that the holding company needs the same type or degree of supervision that we, for example, associate with banks. However, a degree of oversight and inspection authority which focuses mostly on capital, liquidity, and debt service/dividend maintenance considerations at the holding company level strikes me as an indispensable component of any coherent approach to supervisory philosophy and policy, especially in a context in which our primary concern should be the stability of the system as a whole.

Whether we care to acknowledge it or not, a multi-dimensional moral hazard dilemma is already there. That dilemma can best be solved in an environment in which efforts are aimed at heading off problems before they occur and dealing with problems from a position of strength when they do occur. The discipline of the market place -- including the ultimate discipline of failure -- will work best when the system as a whole is strong enough to withstand that discipline and when the authorities are confident enough in their capacity to contain the damage from individual failures. In short, what we want and what we need is a supervisory framework that is flexible, yet firm; one that is sensitive to the realities of the marketplace; but, above all, one that helps us to better cope with the moral-hazard dilemma posed by the systemic risks inherent in banking and finance. A fail-safe system is neither attainable nor desirable but one which protects and rewards the efficient and responsible and severely penalizes the reckless and irresponsible is both attainable and necessary.

Appendix V

EXTRACT FROM STATEMENT
BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK
BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
JUNE 18, 1987

The Separation of Banking and Commerce

While the current debate regarding reform of the banking and financial system has many controversial aspects, one source of debate that is especially crucial to the deliberations of the Congress relates to whether, as a matter of public policy, we should preserve a separation between banking and commerce.

I have spent countless hours deliberating the wisdom of maintaining the separation of banking from commerce. Having done that, I can say, Mr. Chairman, that if my views have changed, they have changed in the direction of further solidifying my judgment that it is in the public interest to have a legislative framework that prevents commercial firms from owning and controlling banks unless there is some absolutely compelling reason to permit such combinations. Since I see no such compelling reason at this time, I remain opposed to such arrangements.

The case for permitting commercial firms to own and control banks is based on a view that says either that there is nothing inherently wrong with such combinations or that such combinations can provide economic benefits in a framework in which regulatory and/or managerial protection can be put in place that will insure that public interest considerations are adequately served. I, for one, have grave doubts on both accounts. In order to make that case, let me begin with several points of reference.

First, when society vests with a select group of institutions certain privileges such as deposit insurance, access to the payments, credit and liquidity facilities of the central bank and the implicit sanctions of official supervision, something of a social compact is created whereby the institution accepts certain responsibilities, most notably the responsibility to conduct its affairs in a safe, prudent and impartial manner.

Second, the central question at issue with respect to the banking-commerce separation doctrine is whether it is desirable for wholly unregulated, unsupervised commercial concerns to be able to own and control depositories having access to the overall Federal financial safety net. In seeking to answer the question we should, for starters, keep in mind that if we in the United States go that route, such arrangements would be unusual among the industrial countries of the world in that in no other major countries are banks, as a general matter, owned and controlled by commercial companies. To be sure, in some countries, such as Germany, banks have greater flexibility in the extent to which they may hold equity interests in commercial companies than is the case in the United States, but commercial ownership and control of banks are not common.

Third, if, as a legal matter, commercial concerns are able to own and control banks, it seems apt to ask would they choose to do so and if so, why? To some extent we know the answer to the first question since at least some commercial firms already own insured depositories and others seem to have an interest in doing so. In that setting, the operative question is why they would wish to do so. Here there can be only three possible answers. First, among the alternative uses of capital, they visualize the relative returns available in banking as superior; second, they see synergies in the combination of banking with existing lines of business that will permit them to maximize the overall return on capital; or, third, they see economic advantages in gaining access to one or more of the privileges associated with banking such as access to the market for insured deposits or direct access to the payment system. Of course in reality, the motivation might well reflect some combination of the above factors. The key point, however, is that if the motivation for commercial companies to own banks is even partly related to the second and/or third explanations cited above, there are clear dangers in permitting such combinations.

Fourth, one might be more inclined to run those risks if there is some absolutely compelling public policy reason to do so. Satisfying the business interests of a relative handful of corporations does not strike me as a compelling public purpose. On the other hand, if there was (1) strong evidence of an absence of competition in banking or (2) strong evidence that combinations of banking and commercial concerns would unleash powerful new economies of scale which did not run afoul of public interest considerations, or (3) if the banking industry was suffering a chronic shortage of capital, one would look at banking and commerce in a different light.

While a case can be made that the capital base of the banking industry should be further bolstered, it is by no means clear that the only way, or the best way, to remedy that problem lies with permitting commercial firms to acquire and control insured depositories. Indeed, it is not even clear that permitting commercial firms to make such investments would materially augment the true capital base of the banking industry. Whether, and the extent to which, that result is achieved would depend, among other things, on the nature of such investments, the prices paid and the manner in which the investment is financed by the commercial company. More importantly, at the end of the day capital will be attracted only by underlying profitability. Merely permitting commercial ownership of banks would seem to do little to change that unless the owners were permitted to push extensive interrelationships which is the very source of my concern.

Fifth, a final consideration which is of relevance in evaluating the case for or against the separation of banking and commerce is the rather straightforward matter of how businesses conduct their affairs. That is, when we look at the manner in which large diversified bank holding companies, financial conglomerates or even commercial-financial firms are managed, do we see -- especially in times of stress -- an integrated approach to management, or do we see parents and offspring each willing and able to go its own way even when one or the other is faced with adversity?

While some observers cite a limited number of examples which they believe provide evidence of failsafe managerial firewalls, I believe that any objective examination of the evidence -- evidence that runs the gamut from advertising to episodes in which firms have taken large losses even in the face of ambiguities about their legal liability -- leads conclusively to the view that firewalls are not failsafe and that, far more often than not, large financial concerns are managed and operated as consolidated entities. Looked at differently, the mere need to set up an elaborate system of firewalls says something about the basic issue of whether it makes good sense to prompt such combinations in the first place.

Taking all of those considerations into account, there are two major classes of risks that must be considered if we are prepared to permit the blending of commerce and banking. The first set of risks are the historic concerns about concentration, conflicts, unfair competition and breaches of fiduciary responsibilities. Interestingly enough, even most proponents of blending banking and commerce acknowledge that those risks are present. In response to this, the proponents suggest that the problem can be dealt with by regulation. However, if regulation is effective, it will, by definition, eliminate the synergies of any such combination such that the commercial firm in question is left only with a truly passive investment. If that is the objective of the commercial firm, there is nothing to prevent such firms from making large equity investments via the open market in any number of banking or financial entities so long as any one such investment does not achieve control over the company in question. Indeed, a commercial firm can buy up to five percent of the stock in any one bank without even having to disclose such an investment.

The second set of risks associated with permitting the merging of banking and commerce are the dangers that such arrangements will involve the de-facto extension of parts of the safety net to any firm that would own and control banks. In response to this point, the proponents argue that the situation is really no different than the situation we have today with the bank holding company. In fact, there is a very big difference and that difference is that the bank holding company -- as an integrated whole -- is subject to official supervision. Moreover, in the reform plan I have suggested, all component parts of a bank or financial holding company would be subject to some form of official supervision, much as they are today, and the company as a whole would be subject to at least a degree of consolidated official supervision.

There is another way to look at the problem. Namely, I assume that even the proponents of merging banking and commerce would agree that the acquisition of a bank by a commercial company would be subject to some sort of official approval process. I assume they would also agree that a part of that application process would have to focus on the financial strength of the acquiring firm as well as the regulatory and managerial firewalls which they agree should be constructed. I assume they would further agree that some such applications would be approved while others would be denied and that some form of ongoing monitoring would be necessary. In making this point, it should be emphasized that commercial firms wishing to own banks undoubtedly will not be limited to a few "blue chip" companies. To the contrary, the list of potential acquires will include all comers -- something I am convinced we should be especially sensitive to in this era of merger mania in which even solid firms can be forced into elaborate defensive financial strategies which undermine their balance sheets.

Therein, of course, lies the dilemma; that is, even the official act of approving an application of a commercial firm to acquire a bank seems to carry with it the extension of at least some elements of official oversight to the acquiring firm in a manner which brings with it -- at least by implication -- an official blessing of the transaction and the relationship in question. As I see it, this subtle but certain extension of the safety net is not something we should take lightly since we must be prepared to live with the consequences in foul weather as well as in fair. Indeed, at the extreme the logic of the matter is unavoidable; if the bank cannot be fully insulated from the entity as a whole, the consequences are either that (1) the safety net surrounding banking will have to be extended -- at least to an extent -- to all who would own and control banks, or (2) the safety net should be eliminated altogether.

APPENDIX VI

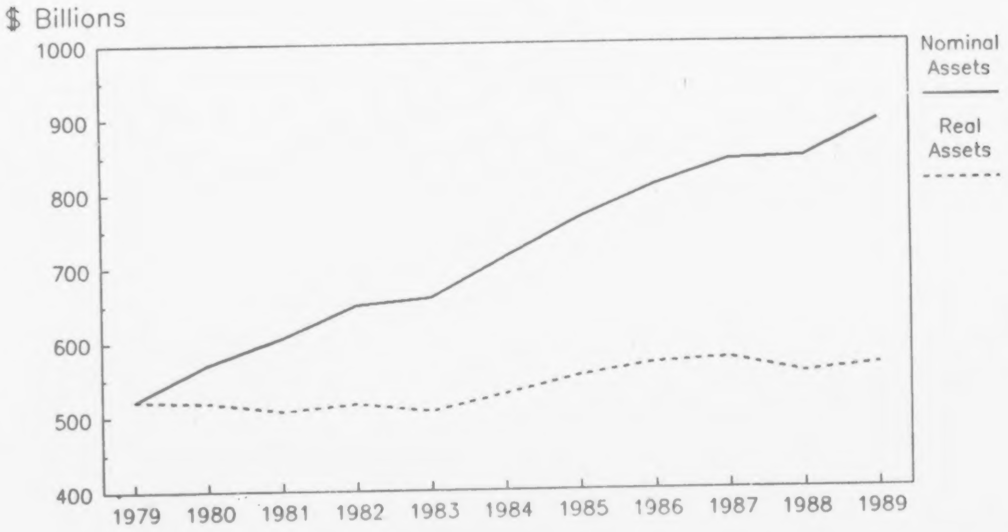
FINANCIAL CONDITION OF THE
U.S. MONEY CENTER BANK HOLDING COMPANIES
IN THE 1980s

May 1990

①

Total Assets of Money Center BHCs

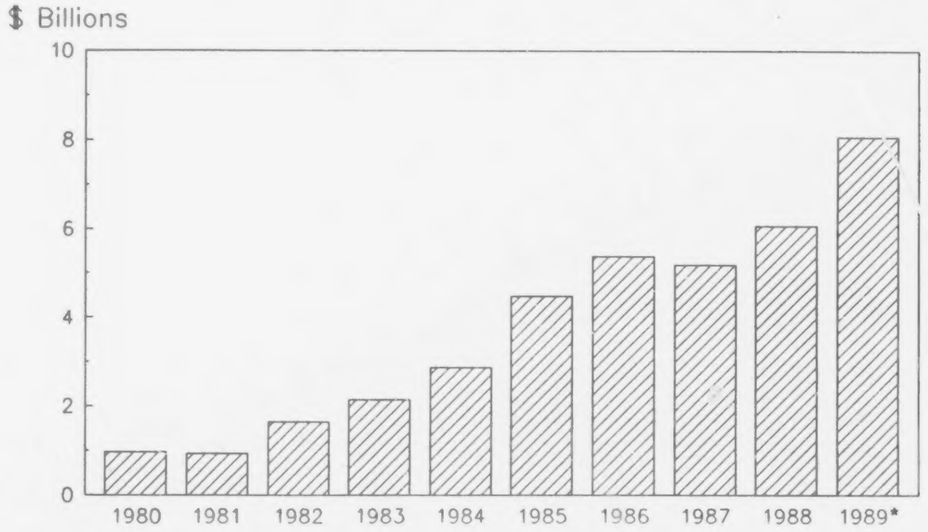
(as of December 31)



The Money Center BHCs are: BankAmerica Corp., Bank of New York Co., Inc./Irving Bank Corp., Bankers Trust New York Corp., The Chase Manhattan Corp., Chemical New York Corp., Citicorp, First Chicago Corp., Manufacturers Hanover Corp., J.P. Morgan & Co. Inc. and Security Pacific Corp.

②

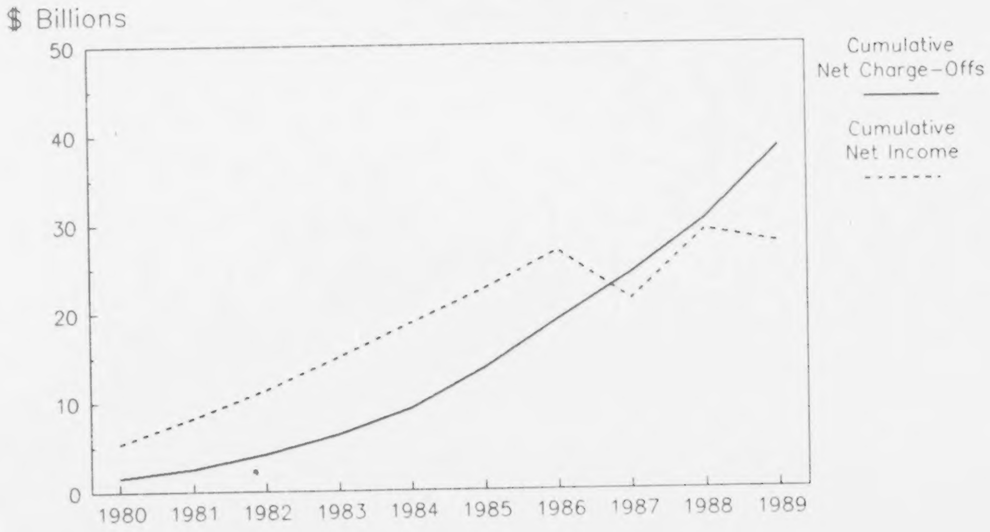
Net Charge-Offs of Money Center BHCs



*In 1989, domestic net charge-offs were $3.5 billion and foreign net charge-offs were $4.6 billion.

③

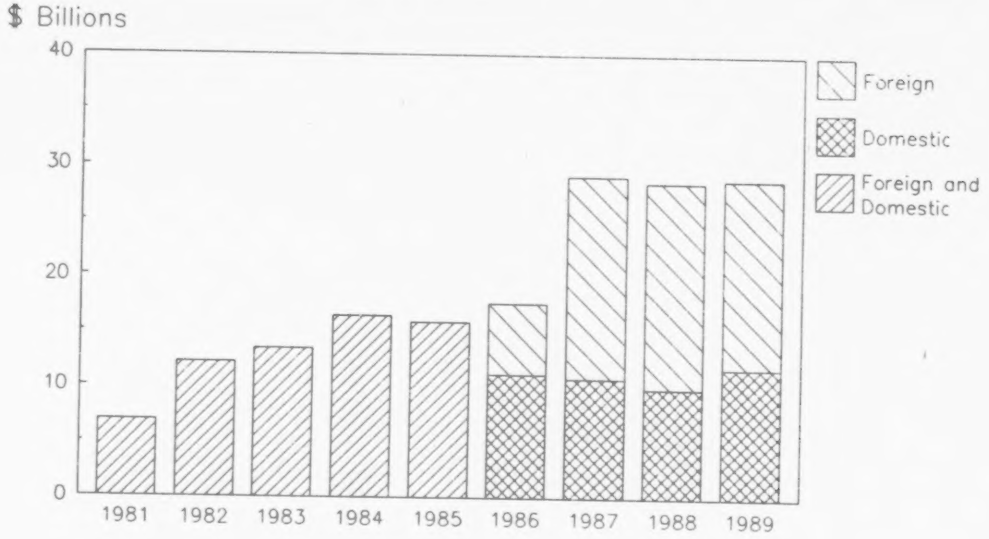
Cumulative Net Charge-Offs and Net Income of Money Center BHCs



④

Nonperforming Assets of Money Center BHCs

(as of December 31)

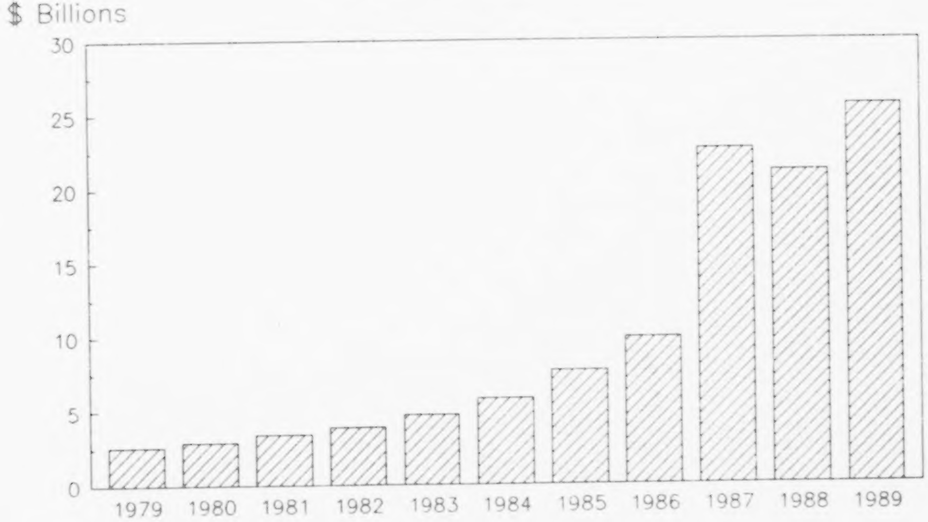


Prior to 1986, only aggregated nonperforming assets were available.

⑤

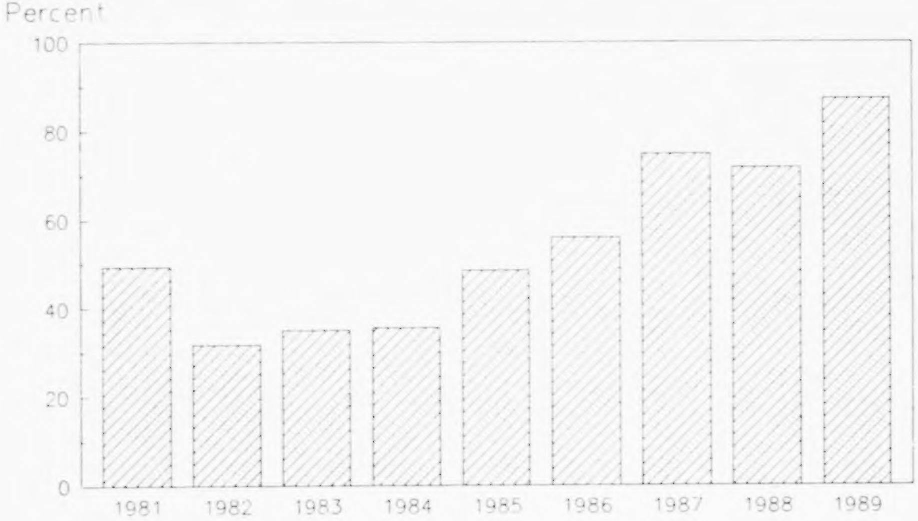
Reserve for Loan Losses of Money Center BHCs

(as of December 31)



⑥

Loan Loss Reserves of Money Center BHCs
as Percent of Nonperforming Assets
(as of December 31)



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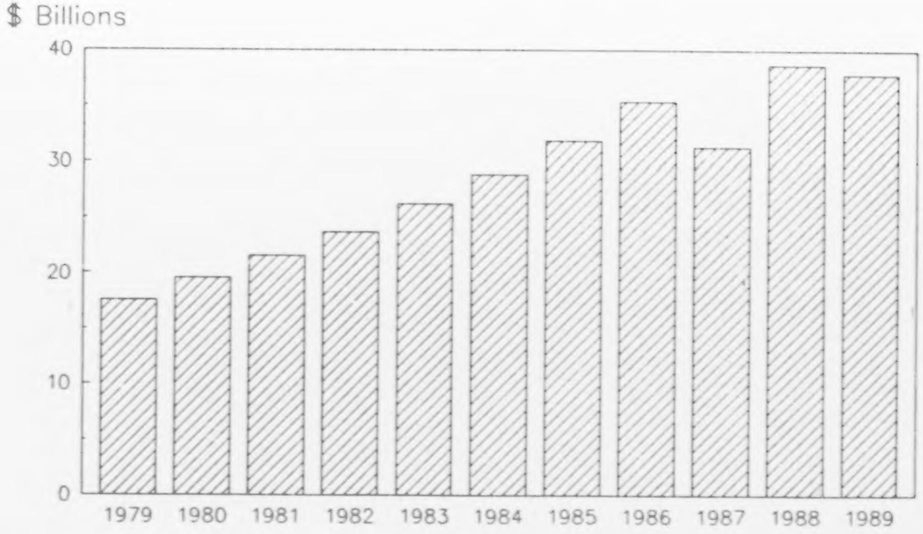
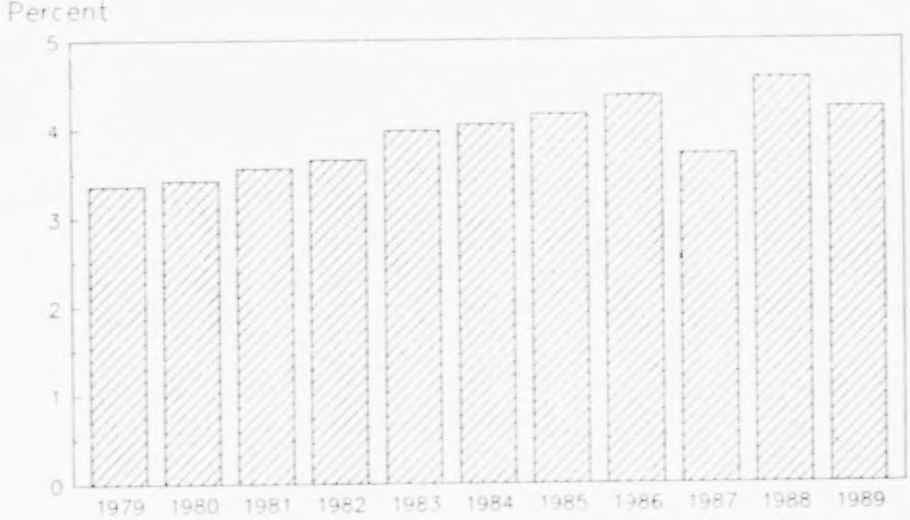
Common Equity of Money Center BHCs
(as of December 31)



⑧

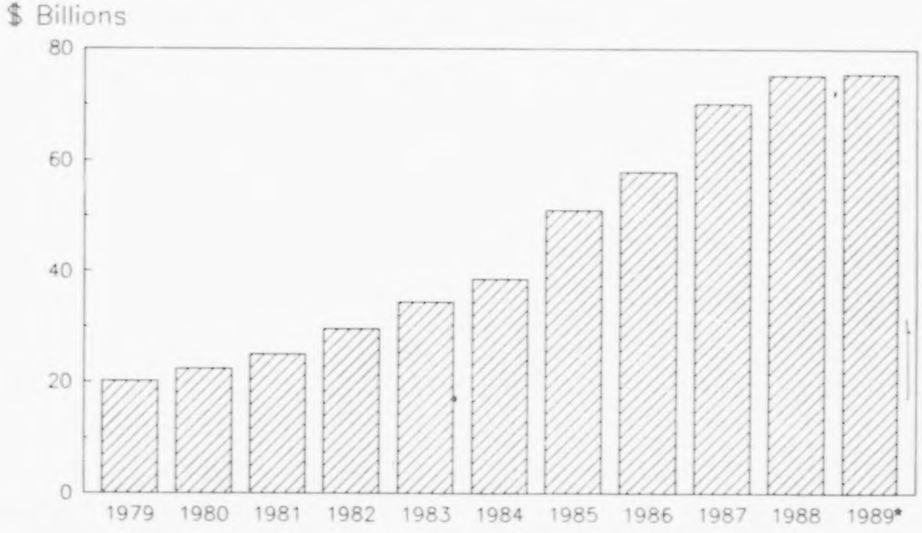
Common Equity of Money Center BHCs
as Percent of Assets
(as of December 31)



⑨

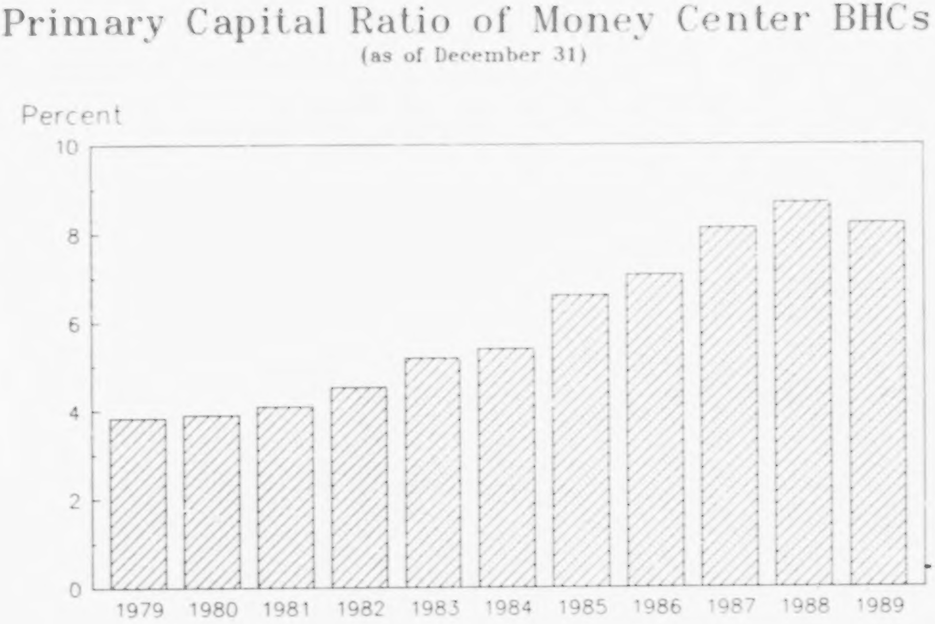
Primary Capital of Money Center BHCs

(as of December 31)



*As of December 31, 1989, the components of primary capital were as follows: common equity, $37.8 billion (48.2%); perpetual preferred stock, $6.8 billion (8.6%); loan loss reserves, $25.4 billion (32.4%); mandatory convertibles, $7.8 billion (9.9%); minority interest, $0.2 billion (0.3%); and, perpetual debt, $0.5 billion (0.6%).

⑩



Primary Capital Ratio of Money Center BHCs

(as of December 31)

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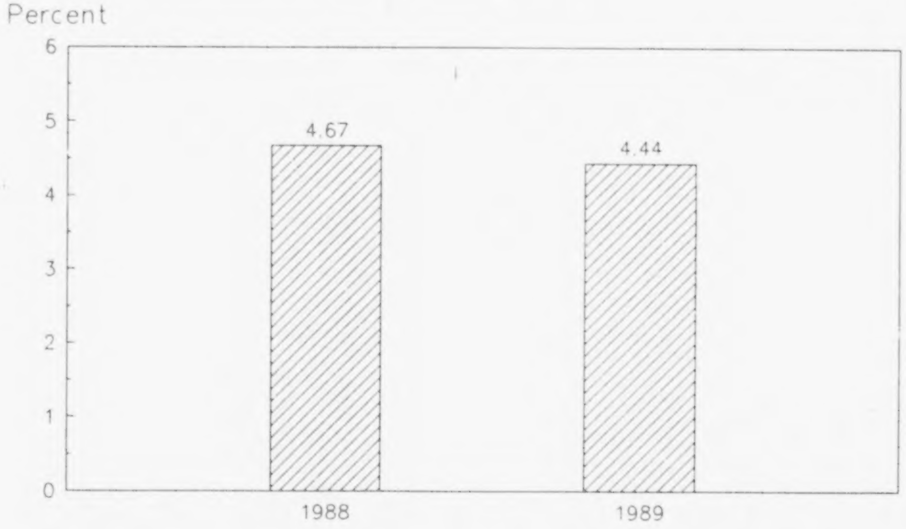
Tier I Capital Ratio of Money Center BHCs

(as of December 31)

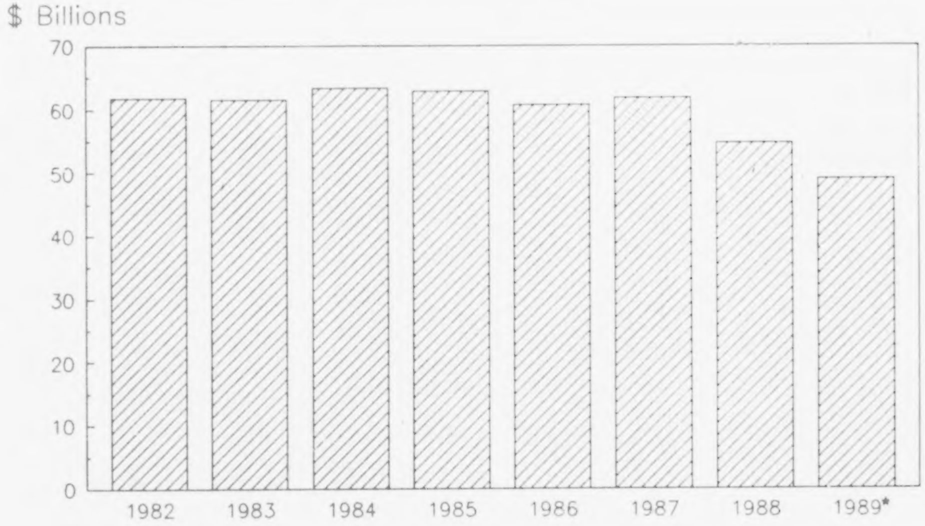


Tier I capital ratio calculated in accordance with 1992 definition.

⑫

Exposure of Money Center BHCs to Baker 15 Countries

(as of December 31)

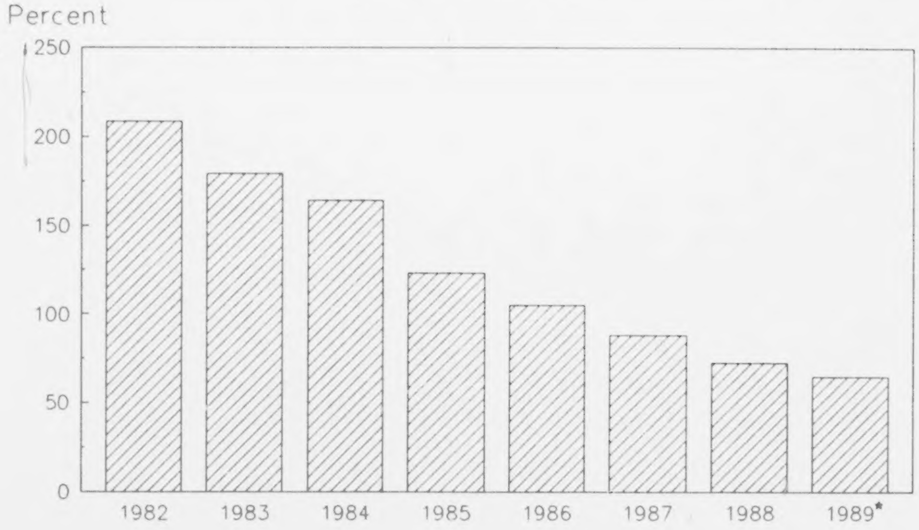


*As of December 31, 1989, the major components of the BHCs' exposure were as follows: Brazil, $15.2 billion; Mexico, $11.8 billion; Venezuela, $5.5 billion; and, Argentina, $3.9 billion.

⑬

Exposure of Money Center BHCs to Baker 15 Countries as Percent of Primary Capital

(as of December 31)

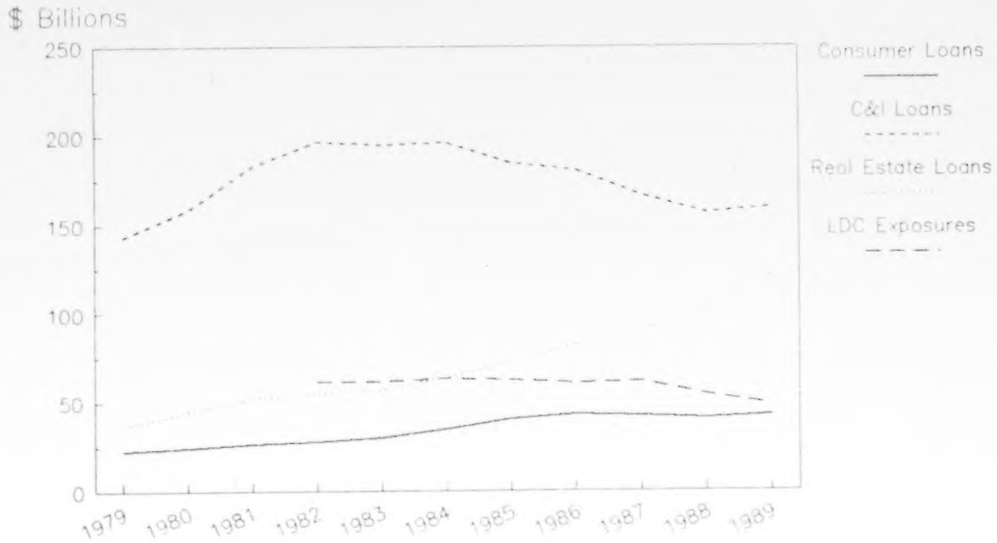


*As of December 31, 1989, the major components of BHCs' exposure as percent of primary capital were as follows: Brazil, 20.1%; Mexico, 15.6%; Venezuela, 7.3%; and Argentina, 5.2%.

⑭

Selected Loans of Money Center Banks

(as of December 31)



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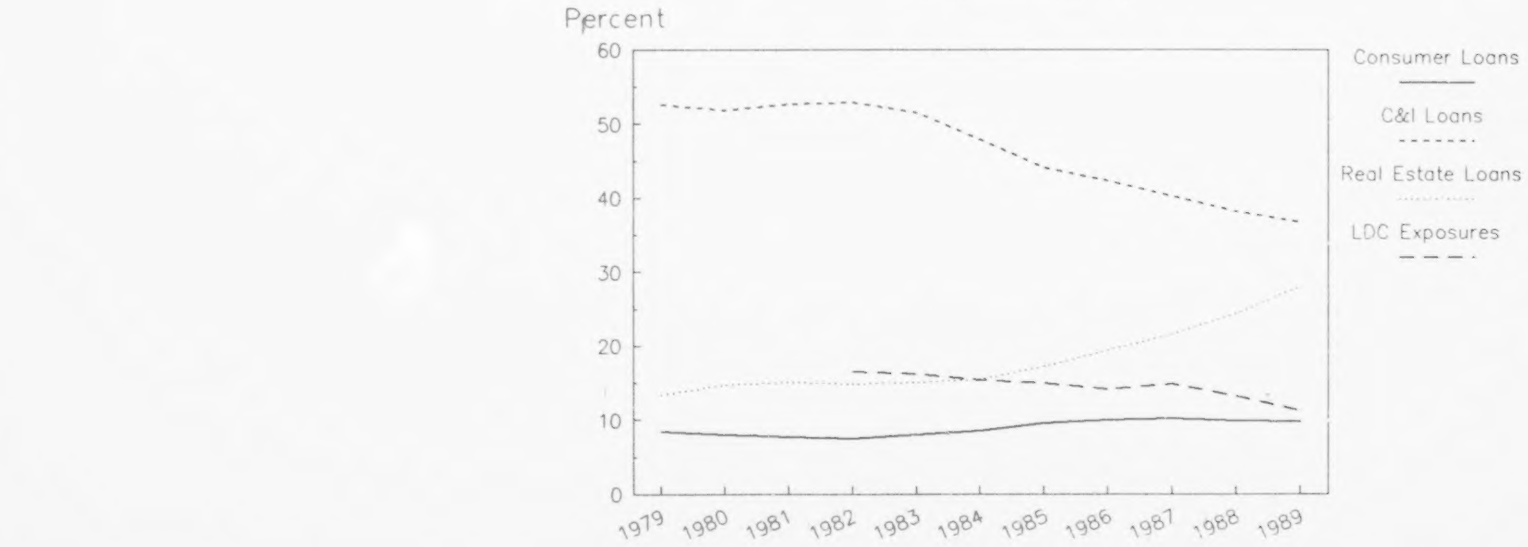
Selected Loans of Money Center Banks as Percent of Total Loans

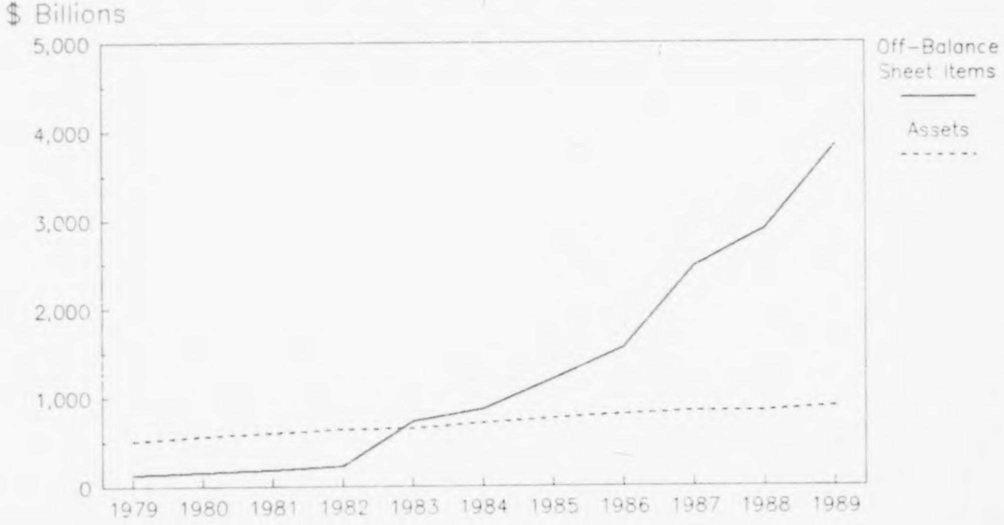
(as of December 31)



⑯

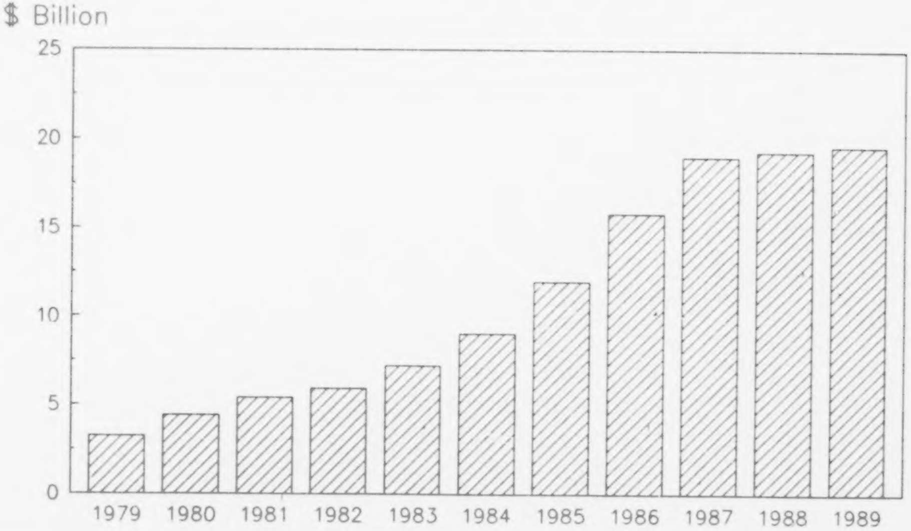
Off-Balance Sheet Items and Assets of Money Center BHCs

(as of December 31)



⑰

Noninterest Income of Money Center BHCs



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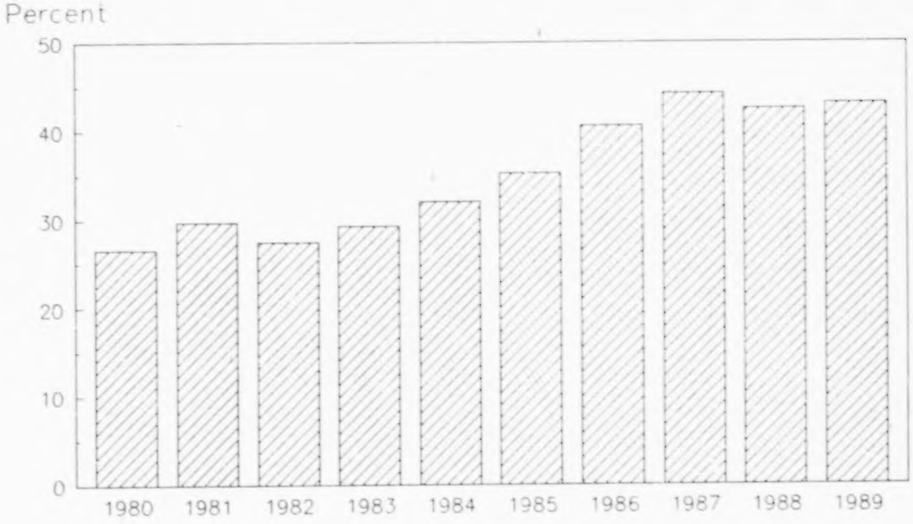
Noninterest Income of Money Center BHCs
as Percent of Total Revenue



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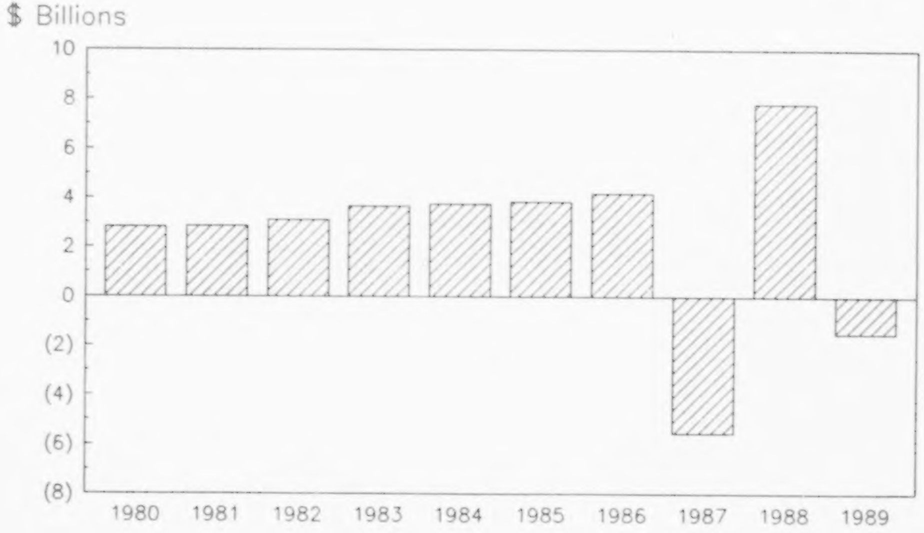
Net Income of Money Center BHCs



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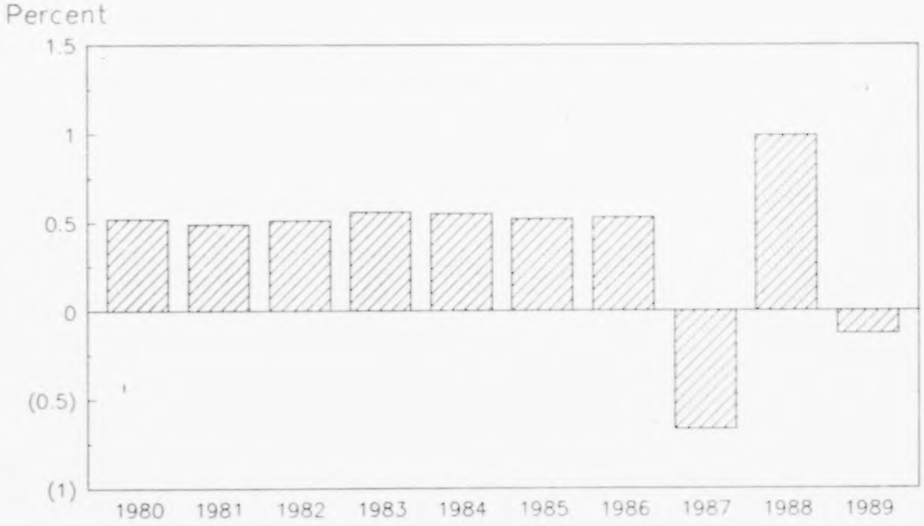
Average ROA of Money Center BHCs



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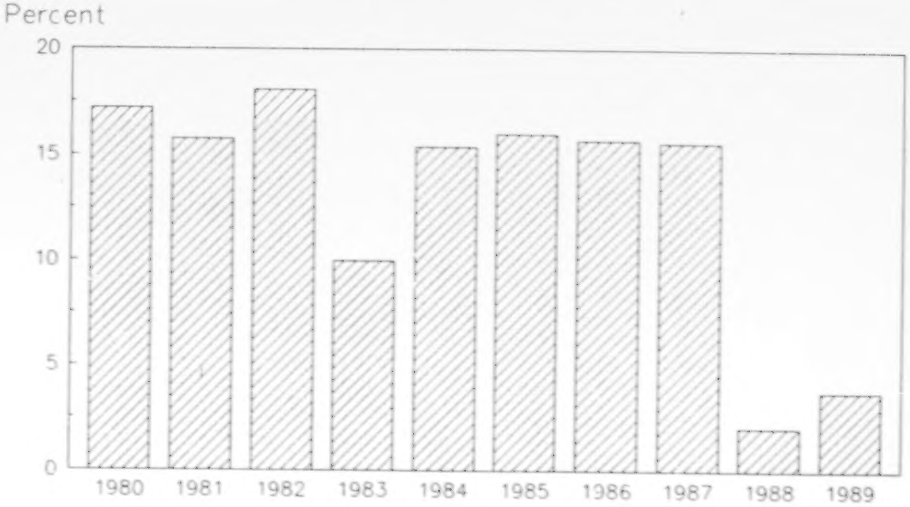
Annual Growth of Noninterest Expense
Money Center BHCs



PRESENTATION NOTES

Chart 1: Real assets were computed using the GNP deflator.

Chart 4: Nonperforming assets are nonaccruals, renegotiated loans, and other real estate owned (OREO).

Chart 9: 1979, 1980, and 1981 primary capital were estimated by adding common equity to the reserve for loan losses.

1989 primary capital excludes the estimated primary capital of Section 20 subsidiaries.

Chart 10: 1979, 1980, and 1981 primary capital ratios were estimated by adding common equity to the reserve for loan losses.

1989 primary capital ratio excludes the estimated primary capital of Section 20 subsidiaries.

Chart 11: 1988 tier 1 capital ratio does not include First Chicago Corp.

Chart 12: The Baker 15 countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, the Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia.

1989 data for BankAmerica Corp., First Chicago Corp., and Security Pacific Corp. are as of September 30, 1989.

Chart 14: LDC exposures are to the Baker 15 countries.

Gina G. Riela
Federal Reserve Bank of New York
May 1990

The CHAIRMAN. Thank you very much. You've given us an enormous amount to reflect on. Before I start in with my own questions, let me call first on Senator Graham and then on Senator Dixon for any opening comments they wish to make, and Senator Shelby.

Senator GRAHAM. Mr. Chairman, I have no opening statement. I wish to thank you for holding this series of hearings and I particularly appreciate Mr. Corrigan sharing his wisdom with us today.

The CHAIRMAN. Very good. Senator Dixon.

Senator DIXON. Mr. Chairman, I will simply put my opening statement in the record, but I want to congratulate the distinguished witness on what I consider to be a very excellent suggestion to this committee about a lot of things we have to seriously look at and I look forward to the Q and A to be further enlightened.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the committee continues its current series of hearings on modernizing financial services law. I am pleased to see that the distinguished president of the Federal Reserve Bank of New York, E. Gerald Corrigan, is our witness today. His thoughtful and insightful approach to international competitiveness and structural reform issues is well known. I am sure that President Corrigan's testimony will greatly help the committee as we seek to come to grips with these issues.

At the outset, I would like to make just a couple of points about international competitiveness. First, I believe that too much can be made of the fact that U.S. banks no longer dominate the rankings of the largest banks in the free world. The world's largest banks are now Japanese, and I believe that fact is based in significant part on the strength of the yen vis-a-vis other currencies and on Japan's overall balance of payments surplus position. Our relative decline is based in some part on the converse: the decline in the strength of the dollar, at least until recently, and our persistent and seemingly ever-growing balance of payments deficit.

The consensus view of economists, as I understand it, is that, at the size levels we are talking about, there are no longer significant economies of scale in becoming larger. Further, I would note that U.S. banks are significantly more profitable on a rate of return basis than their Japanese counterparts, and that our banks continue to be the world's leading financial innovators.

Having said all that, however, I recognize that the international competitive position of the American banking industry is eroding and that our failure to address structural reform issues is an important contributor to our growing competitive problems. Foreign banks are already a major presence in U.S. markets, and their share of our market continues to grow. Moreover, foreign banks are stronger in their home markets than our banks are in our market, which gives them a significant competitive edge.

We have already waited far too long to begin to come to grips with these problems. I want to see the United States continue to be the world's financial leader. Part of that leadership is based on the strength and competitiveness of our banking industry. We therefore need to get on with the process of reforming our banking system.

The CHAIRMAN. Thank you.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement I'd ask unanimous consent to be made part of the record and I look forward to the testimony and I'm glad to have him before the committee again.

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling this morning's hearing and appreciate your inviting today's distinguished witness.

Mr. Corrigan, we appreciate your taking the time to appear before this committee today. I have looked over your testimony. You have submitted a comprehensive document that I believe will prove to be very helpful in the coming months as we continue to discuss this subject.

Particularly useful in your testimony is the discussion of the structure of the financial services industries in other nations. However, I believe that we must consider the scope of these activities against the scope of the deposit insurance systems. It is my understanding that in most nations, the Federal deposit insurance provided per depositor is much more limited than the present system in the United States. In spite of the huge cost of the savings and loan crisis, the deposit insurance system in the United States has served this country well, providing security and peace of mind to small depositors during times of economic instability.

Thus new bank powers will have to be considered in the context of minimizing risk to the deposit insurance system. It is extremely useful to compare other systems of financial regulation to our own, in order to see how the regulatory structure provides for the safety and soundness of financial institutions abroad.

Mr. Chairman, I look forward to the question and answer period. Thank you.

Mr. CORRIGAN. Thank you, Senator.

The CHAIRMAN. Mr. Corrigan, the number of Senators present this morning is an indication of the seriousness with which the committee takes this subject and your thoughts on it. Senator Garn had to leave for an urgent matter in the Appropriations Committee. As you know other committees are meeting and so some of our members are not now present. But they have indicated to me that they have a great interest in the subject and will come and go as best they can arrange their schedules. Already you can get some measure of the fact that we intend to see that any changes that are made are well and carefully thought out as possible.

I take from what you've said that you think that having to adjust to this global economy is a problem. Looking at the performance of American financial institutions, and banks particularly, we seem to be sliding backward in terms of our relative position. That is a cause for considerable concern to you.

What are the risks here? What if we failed to make intelligent adjustments to match us better with the rest of the world? What is the risk of continuing to have a patchwork, absent of some kind of a fundamental realignment or rearrangement?

Mr. CORRIGAN. I think, Mr. Chairman, those risks have to be thought of, in my judgment, on three levels. The first is the risk—the direct risk, if I can put it that way—of the continued loss of competitiveness on the part of our financial institutions themselves.

The reason why that's important is because to the extent that loss of competitiveness continues or accelerates, it impairs their profitability, it impairs therefore their ability to raise capital, recognizing that the principal source of capital for most companies but especially financial companies is internal, retained earnings; and as that occurs, it seems to me it also brings with it the risk that in an effort to try and stay even they get drawn into more riskier types of activities and then you really do have kind of a self-fulfilling prophecy.

So those issues in and of themselves I think are important.

There's a second level of concerns or risks that I would simply and loosely call the loss of financial influence, broadly defined, that goes with that process. And that is not an incidental or a trivial thing, for example, in terms of the extent to which our major companies operating both in the United States and abroad find it more convenient to do business with foreign firms than U.S. firms. I think that's something we have to be concerned about.

Then I think the greatest risk of all is that if our financial system's relative importance does in fact decline in any further and significant way, it does seem to me that it calls into question ultimately our ability to finance ourselves from abroad, as we have to do these days, and as I suggested, at the extreme, it might even call into question the ongoing role over time—a long time—of the dollar as the world's reserve currency.

So whether you look at it at the level of individual firms or in a more cosmic sense, it seems to me that the issues here, the risks here, are profoundly important.

The CHAIRMAN. Now, I appreciate what you are saying. You talk about the fact that other countries provide—in one form or another, even more deposit insurance than we do, in a sense, a kind of systemic insurance. What are your thoughts about what we ought to consider doing with deposit insurance here? How specific can you be in responding to any of the different ideas as to how the deposit insurance system in this country might be changed?

Mr. CORRIGAN. Well, let me again emphasize what I think was implicit in your question, that in de jure terms, the systems abroad, if anything, look a little less robust than they do in this country, but my suggestion was in de facto terms. They are either about the same or a little more robust.

In terms of the deposit insurance system, again, I preface my specific answer by saying once again that this is a package deal, that if we do not have appropriate strong supervisory standards, if we do not have a system that is competitive in underlying terms, you are tilting at windmills.

But within a framework in which we have those things, I would first say that the need to even think about fundamental reform of the deposit insurance system in and of itself is diminished. I mention in my testimony that in my estimation the worst single abuse of the deposit insurance system has been the abuse of the broker deposit system arrangements, and I think that if we could fix that by finding a workable way to limit the $100,000 insured deposit to each individual or each taxpaying entity, that would be a step in the right direction. I do think that some of these other ideas that have been talked about—for example, progressions of regulatory actions—might make some sense. But again, I think we've got to be careful here not to delude ourselves into thinking that there is a cookbook there.

So I think there are some sensible things that can be done, but they've got to be done, and they've got to be looked at, in my judgment, in the context of this package deal.

The CHAIRMAN. Can I just ask you in addition on that point, about BIC's, which you are familiar with. The question is whether or not they are an example, or quasi example, of a brokered deposit?

Mr. CORRIGAN. Now, again, the problem here, Senator, is a kind of an administrative and technical one. It is defining these things in a way that is clear enough and succinct enough and in the process not destroying the legitimate business of money brokerage activities. I am not far enough advanced in my own thinking about the details as to how administratively we would best do that, but I think, as I said, that it is clearly a direction in which we should be going.

The CHAIRMAN. I am going to ask you for the record to take a look at these blocks of insurance funds that are now coming into the banking system, under deposit insurance guarantees. I would like you, on reflection, to give us some further thoughts on their implications, their soundness, or unsoundness. How should we fit them into our scheme.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much. Jerry, you have given us, I might say, a magnificent doctoral thesis by somebody who teaches most of the doctors how to go about administering their practice, and this is quite a contribution that you've made today. It is comprehensive. It is thoughtful, and as I mentioned, it is also consistent with earlier proposals that you have made to us.

Mr. CORRIGAN. I may not be right, but I sure as hell am consistent. [Laughter.]

Senator HEINZ. Let me ask you one question that we perennially confront, and it, in part, always looks like a turf issue, but has, as you may know, many other implications, and that is the banks and securities firms issue.

Now, I am wondering if there is any lesson to be learned from the savings and loan crisis, which we all recognize was, in one sense, an accident waiting to happen, for a lot of historic reasons, a capital allocation system, people lending long, borrowing short.

But the question is, when Congress deregulated, especially to permit state-chartered institutions to do their own thing under state law, and they were allowed to go into other activities in the name of diversification, and you argue, in part, in your discussion, that diversification is a plus, that it should provide more stability.

It would appear that diversification increased risks when S&L's diversified to the deposit insurance system.

Would you agree with that, and if so, why does that not tend to disprove or discount the theory—or your argument that diversification can help?

Just to make it a little more difficult for you, consider the possibility of getting a follow-up question such as what would happen if a bank had bought Drexel Burnham last year, and would that have been a plus for that bank and the deposit insurance system.

I'm not going to ask that, but consider that in your response.

Mr. CORRIGAN. First of all, Senator, in my estimation, the singlemost important direct cause of the savings and loan program was—and I said singlemost important, not the only cause—was the problems with the supervisory apparatus, rather than any inherent fundamental flaw in the architecture of the deposit insurance system or even elements of deregulation.

Now having said that, I think that the experience of the S&L situation graphically underscores some of the points that I try and make about the supervisory process itself. For example, I have maintained for a long time, even though it's not very popular, that there should be some kind of a Federal override, insofar as unlimited activities being granted to federally insured institutions at the State level. That's not very popular, because it goes right into the heart of the dual banking system, and I think the dual banking system is great, but nevertheless should not be allowed to compromise the Federal Safety Net.

Another example, I argue very strongly in this statement, as I have argued earlier, against permitting commercial companies to own and control depository institutions. That would include real estate development companies. And again, I think that one of the particular problems that we have seen in the S&L crisis had to do with patterns of ownership and control some of those institutions.

I also argue very strongly for the principle of consolidated supervision. That would apply not just to the S&L itself but to affiliated institutions, whether subsidiaries or cross stream. So I do think that there are mechanisms, Senator, that can square the circle, insofar as how do you safely get appropriate degrees of diversification in an overall context that makes sense.

On the particular question of banks and securities companies, again, I start with this principle of consolidated supervision. If we had a reciprocal elimination of Glass-Steagall, the way I would approach that problem would be if the dominant company or group is a banking company, the consolidated supervisor would be the Federal Reserve. If the dominant company is a securities company, the consolidated supervisor would be the SEC, and the various component parts would be subject to so-called functional supervision just as we have had it in the past.

As to the Drexel part of your question, you will understand that I'd rather not answer that, but I would say that, again, in my estimation, the Drexel case, whatever else it may be, is, in my judgment, the proof of the pudding, as to the case for consolidated supervision.

Senator HEINZ. I think my time is about to expire. Thank you.

The **Chairman**. I might just say, before calling on Senator Sarbanes for any opening comment that he wants to make, that we took care of the state powers' issue in the FIRREA Act. There is still a question in my mind whether we have a problem in the banking system with respect to state powers, and that gets into the question of the dual banking system. Speaking for myself, that's one issue, I intend to turn the bright light on, when we go through this question of redoing the system sometime next year. Also, I hope at some point today you will talk about whether or not you think the Bank Holding Company Act itself is still relevant. In other words, should we keep one kind of commercial business out of an insured depository institution? I tend to agree with your thinking on that issue. How far should we go? We already have all kinds of anomalies where major industrial companies have come in and are now very much in the insured deposit business.

I would like to get a direct answer from you at some point this morning.

Mr. **Corrigan**. Sure.

The **Chairman**. Let me call on Senator Sarbanes for any opening comment he wishes to make and then go to Senator Graham.

OPENING STATEMENT OF SENATOR SARBANES

Senator **Sarbanes**. Well, Mr. Chairman, I just want to make a couple observations. First of all, I very much want to welcome Jerry Corrigan back before the committee. Second, I want to say that I think this study that you have submitted and the appendices is an extremely valuable contribution. And I particularly welcome this willingness to look at what others are doing and see if we can't learn some lessons or understand what the differences are and gain a greater perspective. I think there is too much of a tendency to think that we are the only ones who know how to do things and that we can't learn from others, and you know, the economic performance of some other countries would lead one to a different conclusion, and maybe there is something we can learn, and I think these studies that are contained in the appendices are extremely helpful.

I assume, Mr. Chairman, we are going to have the president of the New York Fed back with us once we have had a further chance to digest this, because I think you're the person around who is doing the most comprehensive and logical thinking about this problem and is thinking about it in a systemic fashion, in terms of what we need to do.

I assume for you on occasion it is somewhat frustrating or discouraging, since you keep coming back and, you know, you wrote an article 3 years ago, I guess, and now you're back with another statement, and so forth. But I'd just like to suggest to you, in the end you may see kind of your view of things, if not in its totality, at least in large part, become the framework with which we respond to what I think is a problem we are wrestling very hard with how to try to deal with it. So I am just pleased to welcome you back and pleased to see that you are still at it. Thank you.

The **Chairman**. Thank you very much, Senator Sarbanes. Senator Graham.

Senator GRAHAM. Thank you very much, Mr. Chairman, and I would like to remind my colleague, Senator Sarbanes, that legislation has been introduced which attempts to capture the essence of Mr. Corrigan's proposal. Senator Wirth and I have cosponsored it, and we would be honored to have additional members of this committee consider joining us in that endeavor.

Mr. Corrigan, I believe that a point of departure in dealing with any regulatory system is to understand that the reason we have a regulatory system, the reason that we have a service agency in the financial industry is not to serve either the industry or the regulators but to serve broader public purposes.

From that perspective, particularly of service to U.S. commercial as well as individual interests, what do you think will be the consequences over the decade of the 1900's if we do nothing? What changes or what further deepening of current developments will occur over the decade as it relates to U.S. commercial interests and individuals if the financial industry structure continues as it is?

Mr. CORRIGAN. Again, I will try to answer that at two levels. One level is that either the quality of financial services available to the American public, whether defined in terms of households, State and local governments, the Federal Government itself, or businesses will deteriorate or somebody other than our own institutions will provide it. It's that simple.

On a different level, if we don't get on with some of the repair work, if I can use that term, I think we run the risk of having a system that is increasingly susceptible to these bouts of instability, and I don't think I need to remind you or this committee that you can only have so many close calls before you run into a situation where something really does go wrong.

So I think those are the issues, Senator, and I think they are foremost among the reasons why I think these issues are so important.

Senator GRAHAM. In focusing on that deterioration of service by the financial industry to all of its range of customers, what data would you monitor as indicators of deterioration. Where would it begin to appear?

Mr. CORRIGAN. First of all, right now, in my judgment, in one sense we are on the other side of this curve because right now I think that on balance the public at large is a great beneficiary of all of the innovation and technological change that is taking place in banking and finance. The scope, the terms, the prices, the quality of the banking and financial services that are typically available to the American consumer, the American business company today are probably a lot greater than they were in the past. So what I am looking at is more a prospective situation than a current one, and I think the thing that you watch at the risk of an oversimplification is what is happening to the profitability, the underlying profitability of the firms in this business. Because if that underlying profitability begins to erode in any systematic way, that would mean that their ability to continue to innovate, their ability to continue to attract and raise capital, their ability to serve their clients and their customers will ultimately suffer.

Now there is no such thing, of course, as any single indicator or group of indicators that would tell you the whole story. There's a whole bunch of indicators in appendix 3 of this statement that I think are germane to this question. But those are the kinds of things that I think you would look at. That's where you'd see the problem beginning to manifest itself.

Senator GRAHAM. On the second possible consequence, that is, seeking services elsewhere, what would be, in your opinion, the consequences to the American economic and political future if there was a large-scale abandonment of U.S. financial institutions for financial institutions from other countries?

Mr. CORRIGAN. Well, that, I think, is really a large-scale worry. And again, that can happen two ways. One way that it can happen is that foreign institutions displace U.S. institutions in the United States. And the second way it can happen, which is more relevant, of course, to the business sector is that U.S. institutions can simply obtain their financial services abroad. As it is right now, the technology being what it is, you know, if I am the XYZ company, and I have an international presence, not even a big one. I can do an awful lot of what I need to do by way of financial services in London as easily as I can do it in New York. There is no regulation or no law or anything else that is going to change that. If we don't like it, frankly, we're stuck with it. So I think that's the reality, Senator.

Senator GRAHAM. Thank you very much.

Senator DIXON. Mr. Corrigan, I appreciated very much your discussion about the deposit insurance systems and how they compare reasonably well throughout the world. You talked about the de jure system—in the sense that I take it, many don't have the $100,000 or the equivalent guarantee—but you then said, de facto, they're even stronger. In other words, I take it that you're saying that the full faith and credit of the Government is behind it anyway, so that in many cases it is a stronger system. Then I thought you also suggested that in many countries there is sort of a private sector involvement, and I wonder whether you aren't inferentially leading to endorsement of some kind of a risk-based deposit insurance system which I've been talking about for sometime, at least for the larger institutions.

Mr. CORRIGAN. Let me back up, if I may, just a bit, Senator. I have tried, especially in the written statement here, to be meticulously careful in how I characterize situations in other countries. But I think the broad thrust of your paraphrase is close enough, but I do want to be very careful about characterizing arrangements in other countries, so as not to do any disservice to our friends abroad.

On the specific question of risk-based deposit insurance—well, before I get to that, one other comment, on the role of the private sector. In a number of these other countries, there is a formal, as I said, limit on the amount of de jure insurance akin to our $100,000. But one important difference in a number of cases is that the deposit insurance fund itself is run and administered by the banks themselves or a kind of self-regulatory organization within the banking system. So again, in de jure terms, there is less of a linkage, if anything, between that insurance system and the full faith and credit of the Government of the country in question. But yet, as I say, it seems to work pretty much the same way anyway.

I have to say, Senator, that I don't think I am a great fan of risk-based deposit insurance premiums. In principle, it sounds great, and I have thought about it a lot, and I come up against some problems. One, I suspect that in order to really have those differential premiums influence behavior, they'd have to be pretty sharply differentiated. I don't think a few basis points would make that much of a difference. And I may be sufficiently battle scarred, and if I am, I apologize—if you differentiate between them that much, then the guy that's paying the heavy premium is going to think he has a license to be really risky in the way he conducts his affairs.

So there is a danger of creating some kind of a perversity here—as I said, I am so battle scarred, I am the only person who would think of it—that does give me a bit of concern.

So it is something that I think about, and I think we should all think about, but I don't consider it a gimme putt.

Senator DIXON. Well, for a quick follow-up, would you say the $100,000 is about right, too low or too high?

Mr. CORRIGAN. I'd leave it where it is.

Senator DIXON. OK; fine.

Number 2, on the safety net. You talked about it being similar to here in other parts of the world, but you pointed out that really nobody has had the very dramatic experience we have had with the so-called "thrift bailout" and so forth. And I heard you say in part of it what I think is the truth, and that is that the supervisory problems have led largely to the concerns we have now. Have we adequately corrected that?

Mr. CORRIGAN. I think that the combination of initiatives that are now on the table and beginning to work their way through the system should go a very, very long way in that direction. It is going to take some time, of course.

Senator DIXON. Well, if I could interrupt at that point, because we are all limited in time.

If you like the insurance system basically the way it is, and that is kind of how you come down here, and if you say we have corrected it pretty much, are you suggesting that probably we have mostly answered the problems out there, so we don't have to look at an experience like this again in at least the short-term?

Mr. CORRIGAN. No, I wouldn't go that far, Senator.

Senator DIXON. Then what would you suggest we further need to do?

Mr. CORRIGAN. Well, again, as I said, I think we've got to further strengthen various aspects of the supervisory system, as I mentioned. I think that in our institutions in general, we probably need still stronger capital positions.

Senator DIXON. In this bill we passed last time?

Mr. CORRIGAN. Yes.

Senator DIXON. You wouldn't in any way weaken that certainly, you'd leave that or strengthen it somehow.

Mr. CORRIGAN. No. You know, there might be a case to be made for a bit more temporal flexibility, but if anything, I think it goes the other way. I'm not satisfied with the deposit insurance system all in all. I'm not suggesting that it needs radical reform, but I do think there are some sensible things, as, for example, in the area of broker deposits, perhaps in terms of some greater flexibility for the regulators to move more promptly in the cases of troubled institutions. I wouldn't go quite as far, I think, Senator, as your question seemed to imply. I think deposit insurance has to be looked at as part of that overall package deal, that societal compact. We have got to work on all elements of that. But I'm not completely satisfied by any means with all of the features of the deposit insurance system.

Senator DIXON. Mr. Chairman, I notice a yellow light. I can't come back. May I sneak in one more? Would my friend from Alabama take exception?

Mr. Corrigan, one last question. I have pending in the Senate, S. 305, which is basically the Proxmire Financial Modernization Act we passed overwhelmingly in the Senate, and the House has never taken up. I am sure that in your view that falls short of all the things you think we ought to do. But given the difficulty of passing anything that is a very great advancement over present circumstances, I wonder if you would be kind enough in time, if I send you a letter, to look at S. 305. I recognize we are behind the curve now, because of all the changes by the regulators and powers and other things, particularly in the equity parts, and so forth, but I'd appreciate your comments about how the basic framework of that bill we passed once before could be brought up to speed to where we are now, so that we can get something over here and send it to the House and hopefully excite them to at least have a look at it.

Would you do that for me, in time?

Mr. CORRIGAN. I would be happy to do that, Senator.

Senator DIXON. I thank my friend from Alabama.

Mr. Chairman, I have concluded.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Corrigan, in part of your testimony, you say you strongly oppose the merging of banking and commerce like the German model, I suppose, and so forth.

Do you consider real estate commerce?

Mr. CORRIGAN. Yes.

Senator SHELBY. OK.

Mr. CORRIGAN. I can feel the harpoons in my back as I say that. [Laughter.]

Senator SHELBY. You're an honest man, and you've been before this committee before. If we consider real estate commerce, and I don't know how you could define it any other way, why should banks get into real estate, in view of many things, one, commerce. Second, because of our experience in the savings and loan problem, how do we protect the FDIC fund from such future things and risk, if we were to give those powers, or if they were to get those powers other than by legislative means?

Mr. CORRIGAN. Well, again, Senator, I have never been a fan of providing banking institutions, even within the framework of a financial services holding company, for example, with powers to get into the business, for example, of real estate development. Again, we run into some of these fine distinctions and definitions here along the lines of some of the earlier questions from the chairman about how you define broker deposits. But again, if your definition means real estate development or owning construction companies or things like that, I would say no.

Senator SHELBY. Commerce, too, and its highly risky.

Do you know of many things that—I know they're highly profitable at time, but not all the time, that are more risky than real estate and speculation? Building? Maybe commodities.

Mr. CORRIGAN. I'm a little hesitant to make that kind of characterization, Senator.

Senator SHELBY. You're not going to bit on that one. OK.

Would that be then, one of your lowest priorities, as far as giving banks additional powers? I agree, and have supported that we need to modernize—I supported efforts to modernize our banking system. I know things have changed since the 1930's. I know that we have to let our banks compete on a global way, and that is why you are bringing this information, or one of the reasons you are bringing it to us today, this information that you've spent a lot of time on and others have. But I fail to see where, as I have indicated, where real estate is banking. I understand investment banking, commercial banking and other activities are financially related, but real estate, no.

Mr. CORRIGAN. The way this is, I think, likely to come up, Senator, is along the following lines. This banking commerce thing, in my mind's eye, first and foremost centers on the question of, do we care as a matter of public policy, who owns and controls banking institutions?

Senator SHELBY. Absolutely.

Mr. CORRIGAN. And I care. I mentioned once before to Senator Proxmire when he was still with the committee and I increasingly view myself in this way as the whole world is a tuxedo and I'm a brown suit.

The way this issue of real estate will come up, I suspect, is not in that context but rather, what's wrong about permitting a very diversified bank holding company or financial services holding company to have what would be described as a de minimis real estate development subsidiary of the holding company. That's the way I think it will come up, and you know, you can dress that thing up in a way that you can say, well, maybe that's OK. And I even put a bit of an olive branch out in the testimony in that direction myself. But I would be very, very careful about those types of things.

Senator SHELBY. I agree with you.

Isn't a risk-based capital system comparable to a risk-based insurance premium system, in that both systems increase cost to the institution for engaging high-risk activities?

Mr. CORRIGAN. They are similar in one sense, but they are very, very different in another.

Senator SHELBY. How do they differ?

Mr. CORRIGAN. The big difference, and it gets back to the earlier question, is that, in the risk-based capital system, because it applies to the entire balance sheet, on and off balance sheet, we can have and do have very, very large differences in the risk weights. For example, a bank's Government securities portfolio has virtually no capital charge associated with it, whereas its real estate loans have a capital charge or coefficient of 1. Now because the weights apply to such a large mass of things, you can, in fact, have those substantial differences in ways that seem to make sense from an incentive point of view.

Senator SHELBY. Would a risk-based capital system be preferable to the risk-based insurance system?

Mr. CORRIGAN. In my estimation, yes. I think the risk-based capital thing is a very, very important step forward, including because it has for the first time got us into a reasonable proximity of a level playing field internationally.

Senator SHELBY. Risk-based capital would enable you to withstand losses, would it not?

Mr. CORRIGAN. That's its purpose.

Senator SHELBY. Yes.

Mr. CORRIGAN. And on that point of risk-based capital, there is a series of charts in appendix 6 that shows, for example, that the major U.S. bank holding companies now are already well above the 1992 international standards, which I think is a very noteworthy achievement in a difficult environment.

Senator SHELBY. Last, how—and my time will be getting away from me. How will American business be affected or handicapped by our failure, if we do fail, and I do hope we won't, to modernize the financial services industry? Will the European banks be able to gain a stronger foothold in this country because of that after 1992? Is that the obvious answer?

Mr. CORRIGAN. I think that is the direction it goes. Again, that is very similar to the question that Senator Graham asked earlier and the chairman before him.

Senator SHELBY. Absolutely.

Mr. CORRIGAN. I know the algebraic sign. I just don't know the quantity. I know the direction in which it goes, but I can't sit here and tell you that I can be very precise about degree.

Senator SHELBY. Well, we appreciate you coming here. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman. I will be brief, because I've got to head off again, and I hope that I'm not going to be raising a question that's already been posed, but I would like to touch on the area of—I look at what happened, for example, in the S&L industry as—you know, a lot of people talk about it in the sense it is one of the problems of deregulation. I kind of look at it as a problem of lack of supervision. And we are involved in discussions now about the expansion of banking powers. It seems to me that as you expand powers, expand the opportunities for people to make investments, and again, a whole different degree of risks that can be involved in those, that at the same time we are looking at expansion, we ought to be placing as much emphasis, if not more, not only on the numbers of supervisors out there, but on their quality, their capability to be able to sit down across the desk from someone who is very skilled in financial maneuvers. And I would just like to get your reaction to, again, the emphasis that we need to—or do we have to be as concerned as I seem to imply with respect to the need for supervision as we expand powers.

Mr. CORRIGAN. Again, I could not agree more, Senator, and I could not agree more with your point that one aspect of the strength and viability of the supervisory process itself is our ability to attract and retain skilled and qualified people to do those jobs. I don't know if you have ever pondered, maybe by your question, you have, what it's like, for example, when I've got two or three senior bank examiners who are maybe getting paid $70,000, or $75,000 a year, sit down in a room with three senior executives of a major international bank holding company who between them are getting paid $3 or $4 million a year, and these "kids," as I affectionately call them, have to try and persuade these guys that they, the "kids," are right and they're wrong.

That's a very formidable challenge, and when you look at the complexity of the contemporary banking and financial system, it's a very, very difficult job. So, yes, the professionalism of the people is an indispensible part of the equation.

I think, and I can only speak for myself, and my own staff of professional people, they're pretty darn good. I think they are very good, as a matter of fact. But it's not easy.

Senator Mack. Do you have enough?

Mr. Corrigan. No.

Senator Mack. And how about speaking for the system itself?

Mr. Corrigan. I think the answer is no.

Senator Mack. Can you give me an idea of how dramatic that no is?

Mr. Corrigan. I really can't, Senator. Part of the problem here where you say "enough," and I make this point in my statement, again, our banking and financial system is so fragmented, so many pieces and so many elements, that if the system itself were more rational, in a kind of underlying structural sense, that supervisory task itself would, I think, be a lot easier, but I would submit that, without being able to quantify it, that the resources are not all they should be.

Mr. Corrigan, do we make the task even more difficult as we expand powers?

Mr. Corrigan. I think if you expand powers in a context—in which you adapt the other elements of the supervisory process, in some ways, you make it easier, if we do it in a haphazard fashion, then you can make it more difficult. For example, I caution in my statement about taking the notion of firewalls too far. And I raise the spectrum of concern on my part of firewalls turning into walls of fire. You know, to the extent we, in the effort to modernize the system, end up with a gerrymandered system, that would make the regulatory supervisory process more difficult, but, if we can learn, from some of the experience abroad in terms of some of the better mouse traps, I don't think that has to follow at all.

Senator Mack. I would gather from what you've said that you believe that any proposal that we put together for the expansion of bank powers ought to include a portion of it dealing with supervisory requirements.

Mr. Corrigan. Yes. But I also think, as I indicate in the penultimate paragraph of my statement—you don't get to it until page 49. [Laughter.]

But in the penultimate paragraph of my statement I suggest, Senator, that I think that we've got to get the structure of the system right in the first place, and then the reform of the regulatory structure grows out of that. To try to do it the other way around, I think would produce the very kinds of problems that you are concerned about. It would make it even more difficult from a supervisory point of view than less difficult.

Senator **Mack**. OK. Thank you very much. Thank you, Mr. Chairman.

The **Chairman**. Senator Sarbanes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Mr. Corrigan, this committee yesterday reported out a major housing bill by a vote of 16 to 4. Efforts to sort of put together a major housing bill have been going on for about 3 years and included a very large number of hearings, the establishment of a private sector housing task force chaired by Jim Rause and David Maxwell, to try to bring together all segments of the private sector to consider what their differing viewpoints were and see if there is some way to harmonize them. Unfortunately, we are now in a situation of having to deal with the administration on this thing, partly over money and some other concepts.

But the question I want to put to you, because you've put forward, I think, a very balanced approach. You're trying to fit all the pieces together. If we convene the private sector colloquium on this approach, where would the opposition come from and to what elements of the approach would the opposition be directed?

Mr. **Corrigan**. I think, Senator, that the three points of perhaps the greatest contention would be three that I tried to deal with in some length in my statement.

First would be this bank and commerce question.

Senator **Sarbanes**. Are those the three points that you say you are in the minority——

Mr. **Corrigan**. Yes.

Senator **Sarbanes** [continuing]. Or perhaps even wandering in the wilderness?

Mr. **Corrigan**. Yes.

Senator **Sarbanes**. Why don't you elaborate on that a little bit.

Mr. **Corrigan**. That's right. It does seem to me that there are many voices, including a very large number of people whose opinion I respect enormously who would be willing to do more in that area than I would. But on the other hand, there are some very, very prominent bankers and others who probably are even more hawkish than I about it. But I think that that would be a very contentious issue.

Senator **Sarbanes**. And is that from the bankers who want to get in the commerce or the commerce people who want to get into banking?

Mr. **Corrigan**. Both. Clearly, the banks feel—and with some justification—you cannot dismiss their point of view very lightly here—that, with so many commercial firms now assuming very prominent roles in the financial services businesses, as I said in my statement, such as this latest development with AT&T going into the credit card business they should have greater flexibility in terms of being able to have nonfinancial business entities as part of their overall companies.

On the other side, clearly, you have commercial companies, as illustrated in commercial companies that acquire thrifts, who seem to think that makes some sense from their point of view as well.

What people tend to do is say, "Oh, well, you know, we can make these exceptions." And my problem is—you know, I could probably live with some of the exceptions, but I don't know how you limit it once you let it go. And again, I deliberately called it hyperbole, but it seems to me if you're going to say, OK, you have to ask yourself the question of would you care, as I say in my statement, if we ended up with, Exxon owning Chase Manhattan, Ford owning Citibank and RJR Nabisco owning J.P. Morgan. Now I care about that. And again, the argument is often put—"Well, those are extreme cases." And maybe they are. But I don't know how you have it both ways.

So that would surely be an area, Senator of some contention.

The consolidated supervision issue, I think, would be far less an area of contention today than it would have been 2 or 3 years ago. But even there, if you look, for example, at the proposal of the SIA, which I thought was very interesting in its own right, the mere fact that it's there, that's a bitter pill for some to swallow. And of course, it is related to the banking/commerce question.

And then I think this question of Chinese walls/firewalls would be the other question. But having said that, as I'm sure you know, I talk, not just to the banks but to the investment banks and insurance companies, and I must say that I think there is a considerable element of, I wouldn't call it snuggling up, that would be a little too much, but there, I think, are elements of a central tendency of thinking beginning to develop here.

Senator **Sarbanes**. Now on page 41 of your statement, you make the point that we allow banking and financial institutions to operate with a higher degree of leverage than most other classes of institutions. You see that as economically and socially desirable, because it helps to mobilize savings and investment, and of course, it is, in a sense, an advantage, an ability that is given to people in that field that is not available to others. And you've put it here in terms of the supervisory function. In other words, that is why we have a greater supervisory control. It also might well, in a way, touch on the commerce/banking distinction too.

To what extent do you think the people in the industry have an attitude that perceives that distinction and accepts the responsibilities that flow from it? And in particular, to what extent is there the attitude, well, we have a certain unique position. It carries with it important safety and prudence requirements. It means we ought to be able to make a good living, but it also means we can't be the high rollers, and we can't make—you know, we don't function with the high roll of the dice and the big payoff and this tremendous profit. That's now how we can function in this business, because we are given, in effect, certain authorities, and we can't be out there gambling, in a sense.

Now to what extent is the prevailing attitude, or to what extent has that attitude—if it used to be the prevailing attitude—been eroded, so that there's—well, we got to get this power, and we got to get free of this supervision and so forth, because in the short run, it may give us the chance to make more money. We can handle it. There's no problem with us. We're the good guys. We can handle it, and let us go ahead and do it. We'll make a lot more money if we can. And as far as the system is concerned, well, you know, it's really not going to happen, or somehow the supervisors can keep the bad guys off, let the good guys go.

Mr. CORRIGAN. Well, I think you have asked that question for the very same reason that I chose to put those several pages in that statement, because I think that an understanding of what I like to call a philosophy of this whole mechanism is vitally important. There is, in my judgment, a societal compact here that for centuries has been at the heart of what makes the banking system, the financial system special. And I guess I would have to concede, Senator, that at least around the edges—maybe we could debate a little bit about how far around the edges—I think that there has been some tendency to lose sight of those principles.

I find some of the, again, relatively isolated, but nevertheless, quite spectacular manifestations of the breakdown in that basic frame of mind that we have seen, again, not just here in the United States, but in other countries as well. I find those things utterly shocking.

Having said that, I do think that we must also recognize that, to the extent that we can get things right in a structural sense and right in a supervisory sense, it works in the direction of taking some of these perverse incentives out of the system.

So I share your concern, Senator, yes.

Senator SARBANES. Well, I see my time is up. Thank you very much.

The CHAIRMAN. Senator Graham, let me call on you. I know you've got a pressing time problem.

Senator GRAHAM. Thank you very much, Mr. Chairman. I apologize, I am going to have to leave, but I wanted to follow up, I think, on the line of questions that Senator Sarbanes has been asking and that I asked earlier, and that is, a process that might move this issue. Starting with the premise that we have this financial industry in order to serve the needs of other sectors of our society, and you have indicated the disadvantageous circumstances that you think are going to start to befall other elements of that society, if we do not move to adopt some reforms, do you see some expression of that concern and interest from those other sectors?

Senator Sarbanes asked who our enemies were; I'd like to know who our allies are in this reform effort.

Mr. CORRIGAN. Well, as I said, Senator Graham, I really do sense among the leaders of major banking institutions, investment banking companies, and insurance companies that there is a different level of recognition about some of these problems than was true a year or two or three ago. The different level of reaction, I think, comes from two or three things. One, the international competitive threat is seen a little more graphically than perhaps it was the case in the past.

And second, this reoccurring pattern of bouts of instability that we have had in various segments of the financial markets has had a rather important impact on the thinking of a lot of people as well.

I must say, it has had an impact on my thinking, as someone who is frequently in a position of having to babysit these things into some sort of order after the fact.

So I think for those reasons, if for no others, there is some movement among prominent elements of the community. Again, just the fact—not that I would embrace every feature of it—that the SIA put the proposal on the table that they did 6 months ago or whenever it was, regardless of what you may think of it, it seems to me that that itself is a rather important indication of something.

Senator GRAHAM. I am interested in people outside the financial industry. We heard some testimony within the last week, and I asked what would happen if financial institutions in the United States couldn't serve your interest? The answer was, we'll go to London or Tokyo, without any apparent pause or reservation about that shift.

Do you sense that in that user community, that there is sufficient awareness of the seriousness of these issues that it will be a proponent of reform?

Mr. CORRIGAN. I would think among chief executive officers and chief financial officers of major multinational companies, there certainly would, but one of the problems with this set of issues——

Senator SARBANES. There would be a——

Mr. CORRIGAN. Yes, there would be.

Senator SARBANES. They're not sort of working the system to their immediate advantage?

Mr. CORRIGAN. Look, they work it. There is no question about that, but I think the sensitivities are there. For example, I know how a number of these people reacted to the 1987 break in the stock market. That got them thinking about some of these issues in ways that heretofore they had not. So, yes, clearly, Senator, they work the system. As I say, the most creditworthy of these large companies, and I don't have any problem with this per se, not only bypass the banking system, they bypass the investment banking system as well. This is disintermediation in its fullest form.

But the problem, Senator Graham, in the context of your question, and the problem that I am sure you face in some ways more than I do, because of your association with this committee, is that these issues don't seem to have a "here-and-now" bite to them. And because of this it's very, very hard to get people to really focus on them. It is like trying to get large segments of the American public to focus on what it means for this country to be running a $100 billion current account deficit. For large segments of the population, they don't even know what the current account is, much less know whether they should worry about it or not.

That is part of the problem here.

Senator GRAHAM. My own personal political experience is that before you have fundamental change, you have to have the people that are going to be ultimately affected feel as if it is important enough for them to get invested. In our State, we had a very constrained unit banking system, and the factor that contributed to altering that was when the business interests of the State concluded that that was no longer serving their interest. The banking industry didn't carry the water to accomplish change; it was the users of the system.

I guess my question is, where are the users of the system as an advocate for reform?

Mr. Corrigan. Again, as I said before, right now from the point of view of most of the users, they are on the right end of the curve, in terms of being the clear beneficiaries of a lot of these technological and other changes. So that is not a constituent group that is going to be on the cutting edge of this kind of issue until, as you say, something goes wrong.

Senator Graham. Thank you.

The Chairman. I want to go over some questions with you here that relate to a lot of things you have talked about today, and we have learned over the last decade. How do we go about the restructuring and rearranging that will have to be done whether we like it or not? Even if we like the old system, the world has changed, and it imposes burdens on us. Another question is, how do we custom-tailor changes in the U.S. system that fit this new global reality?

You have raised all or most, if not all, of the critical issues that have to be looked at and addressed in some form. I am speaking for myself. I am convinced now that we also are going to have to get this done as best we can. The window for doing it, probably, will occur next year. We are doing our ground work now with this kind of discussion and very careful plowing through of these issues. The sense one gets from newspaper stories and other things is that the administration is working on this as part of the deposit insurance reform studies required in FIRREA. They have ideas they are developing. I would assume that sometime late this year or early next year, they will roll out a draft of a rather comprehensive proposal that they have in mind as the kind of restructuring that would serve us best.

I don't know that for a cold fact, but the shadows on the wall would indicate that that is the track that they are on.

We are seeing movement among the outside interested parties. Not all of them, but you cite, for example, that the investment banking community and the SIA are now talking in somewhat different terms than they have before. The debate seems to be loosening up to some extent. It isn't quite as dug in as it was in the past. I think all of these things point toward the fact that there is movement going on here that is being driven from several directions. All of this within the context that the world is not waiting for us. It is rolling ahead. Europe 1992 is rolling ahead. The Japanese are coming in, and taking a larger share of the banking market in the United States day-by-day, so far as I am able to judge. You have a whole host of other things that indicates that the world isn't pausing. The world is moving ahead. Therefore, the burden of change and adjustment, if we need to make an adjustment, really falls on us. We've got to somehow decide what that is and try to make it happen.

I see some important points from our experience of the last decade with the collapse of the savings and loan system, that we need to draw upon. You have done that on a few occasions today. The case facts are different. Go back to the early eighties, to the elimination of regulation Q, with the deregulation of interest rates, then the deregulation of activities at savings and loans and then the state powers issues on top of that.

To me, one of the most powerful financial anomalies that I have seen as we have tried to reconstruct that whole thing, concerns just one item—junk bonds. Federal regulation allowed federally chartered thrifts to have up to 11 percent of their assets in junk bonds. Most did not, of course. The State of California had a charter in place that enabled one State-chartered thrift to have almost 34 percent of its assets in junk bonds, all underwritten by Federal deposit insurance. Direct investment in real estate, which you have highlighted, is another very ~~high-risk~~ area. We have seen that fact not only in the pattern of failures but in the assets that are accumulating in the RTC.

State powers went way out in an extreme direction with respect to direct investment in real estate. We put a stop to that, as we did with junk bonds, in the FIRREA legislation. But that is looking back—looking back over a decade. The central argument being advanced over the decade of the 1980's was that, in order for that industry to be competitive and get on its feet, to work its way out of its problems and be able to earn more, to be able to strengthen its capital through retained earnings, to be able to attract new capital, was that it had to be able to move ahead and do more things.

The States, as I say, added on to that thrust in a very extreme way.

A lot of the same tone is in this current debate. The banks in this country, a lot of them are having trouble. They are not showing great profitability. Bank stock prices have been hammered down. The banks are, in effect, saying, "Look, we've been involved in a whole set of traditional activities, but it is not enough. We can't make money. You've got to give us more things to. We've got to be able to expand in other lines of business."

A lot of the rationale that is being offered has a certain echo of things that we heard before. There are different case facts in some important respects, but nevertheless, the ideas that diversification and new powers are the answer to the problems of sagging profits, insufficient capital and retained earnings are not new.

When I look at the pattern over the last two or three decades at the degree to which diversification has really solved our problems in or out of financial services, I don't see an overwhelming case that says that the way you solve a problem is simply to diversify or build a conglomerate with more and more disparate pieces. Sometimes it works. Sometimes you can see a huge conglomerate that is in all different kinds of things, and it works quite effectively.

There are probably more examples where diversification has been tried and didn't work. I don't know whether you can apply that observation in any meaningful way to the debate that we are seeing here on financial services. But it causes me to doubt that diversification, in and of itself, guarantees success or guarantees greater profitability. Very often when one business moves into a line of business that is new to it but well-known to its competitors, the competitors hang on pretty well. Oftentimes, the new player who goes in, bright-eyed and bushy-tailed, and finds out, after a while that this is a lot tougher business than it seemed, and that the grass isn't really so greener on the other side. They end up oftentimes losing their shirt.

There are a lot of examples on Wall Street of people and financial firms, that have decided to go into other lines of activity that they thought would be very promising—some in this market, some in foreign markets. What you see now is retrenchment and big losses being taken.

I am not sure that diversification, even by sophisticated financial players, leads to automatic success, big profits, and more capital. It works only some of the time on 100 cases taken at random. A lot of the time it doesn't work. And you get disappointing results.

In that philosophic tone, I think whatever we do in this area, we have to do it right, because the risks of a miscalculation truly are catastrophic. We have just had the GAO in here. Bowsher sat where you sat and told us that we may be looking at spending half a trillion dollars on the savings and loan problems, where 500-plus institutions have gone down. Not one or two or a dozen or several dozen, but in excess of 500. I mean, a major systemic failure.

The banking system and the financial system more largely defined are so essential to the well-being of this country, to our security and to our stability, that we must have a very good idea what we are doing. This can not be something that we do it with a hope and a prayer. We have to have a very carefully reasoned, carefully refined set of arguments and cross checks before we do something radical or undertake a radical restructuring. One of the ways to do this is in steps, in phases, so that we have some reasonable chance of digesting the changes as we go. We do not want to find out that we have missed the mark and we have traded one set of problems for another.

I am thinking out loud here, and I want to bring us back to two specific questions.

You raised a flag in my mind when you said that firewalls overseas are not well-developed. While those folks work very hard to keep their system from flying apart they too are being subjected to global changes. Any shortfall in firewall protection over there, in an integrated world system, can reflect back on us, especially if these institutions—part of financial conglomerate partly banking, partly investment banking—constitute a larger and larger part of the domestic scene here.

I wonder if there is some likelihood that foreign banking interests as they take up a larger and larger part in the picture here in the United States, being a firewall deficiency that may cause you, as a very conscientious central banking person, to be uneasy. Are we not at some risk here? Do we have, at least, a contingent risk? Can you comment on that?

Mr. CORRIGAN. Sure.

The CHAIRMAN. Then I want to get Senator Wirth in the act here.

Mr. CORRIGAN. Let me, if I may, Mr. Chairman, just go back a bit in terms of your views about the system and the nostalgia that you seem to convey. I share some of that nostalgia about an older, simpler world, but I don't think we really have that choice. I think your points about diversification are very well-taken. Some of the most important elements of diversification, however, which seem to me to make a particularly great deal of sense have to deal with geographic diversification, getting rid of the remaining barriers to interstate banking in this country. Indeed, many of the other kinds of activities that one would be talking about within the framework of the reforms I have in mind would be activities that U.S. banks, by and large, are already performing overseas anyway.

So I don't think I have in mind an ambitious agenda of exotic new things. And no matter what we might end up doing, I would strongly endorse the case for very careful conservative transitional rules, and I make that point quite explicitly in my statement.

On the firewall question and the foreign aspects of firewalls, first of all, I don't want you to misconstrue my earlier comments about firewalls. What I was suggesting is that firewalls are generally not present abroad, and they want it that way. The reason, the fundamental reason why they want it that way is that they all view the entity as a whole as what matters in terms of liquidity and solvency. So they don't accept firewalls. They, in effect, say, if part of a company gets in trouble, the rest of it is going to be contaminated no matter what kind of firewalls you have.

And I think the burden of experience rather strongly points in that direction. That is one of the reasons why I get a little concerned about what I call taking the firewall theology too far. I think we have got to have protections against conflicts of interest and concentrations, unfair competition, and we have got to be mindful of deposit insurance systems, but we can't delude ourselves into thinking that firewalls are fail-safe. Experience suggests that they are not. Experience suggests that, when the temperature goes up, the firewall comes down. So I think we have to be cognizant of that.

Insofar as firewall risks or problems that originate abroad are spilling over into this country, this is a very, very complex subject. It is one of the things that in the international community of central bankers we talk about all the time. It is one of the reasons why we adopted the international capital standards. It is one of the reasons why have this international committee on bank supervisory matters. It is one of the reasons why we now have a group through the BIS looking at these issues relating to the workings of payment systems on an international basis.

This is a very, very important issue that is rightly high on the agenda of coordination and communication among the international community of bank supervisors and central bankers.

The CHAIRMAN. I want to just make one comment and then yield to Senator Wirth. Take the collapse of Drexel Burnham—the money in the brokerage area has a form of insurance behind it. As they began to go down the drain, they upstreamed resources into the holding company. That problem was spotted and stopped before the assets were depleted. It looks as if all the customers, who had credit balances, will not wake up and find that their money is gone. Their accounts can be paid off, apparently dollar for dollar.

But that was a case where a investment banking company, went down for reasons you mentioned earlier—not associated with real estate the premier problem around the country today.

Are there other examples where a major institution, a financial institution, can collapse because it moves money out of one compartment into another—either the holding company or another part of the business. We should be mindful to safeguard ourselves sufficiently?

Mr. CORRIGAN. Well, in the Drexel case, of course, the upstreaming of capital from the registered broker-dealer to the holding company was kind of a symptom. The underlying problem was much more profound than that. So that in evaluating the implications of a situation like that, I think you really have to look at the whole thing, not just that particular class of transaction.

There are, I think, a number of other cases, some uniquely in the S&L area. There are cases even going back to, say, the 1980 problems we had in the silver market, that make for a fairly impressive history of examples of concrete cases where I think there are important things that can be learned and bear on both the structural questions and the supervisory questions.

Your staff may have already seen my recent paper for the National Bureau of Economic Research that gets into some of these issues on a case-by-case basis, but without mentioning names, but your staff could figure out the names that ought to be there.

THE CHAIRMAN. Well, we will take a look at that. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Corrigan, welcome, and thank you for being here. I have three questions. One related to lessons from the S&L debacle. The second, values of the dual banking system, and third, some references to your Tokyo speech of last fall.

First, what in your opinion are the No. 1 and No. 2 lessons that we learned from 10 years of turmoil in the S&L industry that could be applied to the discussions we are having here and going ahead on the overall changes in the financial services business overall?

Mr. CORRIGAN. Well, the first I would cite is the case for a strong, professionally competent, politically and industry group independent supervisory mechanism. I think that is far and away the most important, in my judgment.

The second and it kind of stems from the first factor is that this question of who owns and controls these institutions does matter.

So if I had to reduce to two, those would be the two I would mention.

There is kind of a third one that looms in the background. Of course, one of the reasons why the supervisory mechanism was set up the way it was in that particular case was going back many, many years, of course, because of the tremendous political and social premium we put on housing in this country, which is, of course, fine, but we made housing so very, very important, and rightly so, that I think it may have clouded our vision a bit in terms of what kinds of institutional arrangements surrounding that industry really made sense. Of course, that goes back many, many years.

So those are the things that I guess I would focus on there.

I forget. Was there a second part of that?

Senator WIRTH. That's all. I have a couple more questions.

I know you—and jumping from the S&L as a transition from here to questions about our dual banking system. I think that in some discussion earlier with Senator Riegle, you talked about one of the problems that came out of the S&L industry, and I have heard you talk about this before, was the fact that the States were doing a variety of things or things were authorized at different levels of Government that were not authorized at the Federal level and were not supervised.

That raises the question, as we get into longer-term questions of overall structural change, about what benefits we do reap in the United States from having a dual regulatory structure the way we have now.

Is there a benefit to doing that or should we be saying, well, maybe that is something that we should not do any more, given what we learned in the past and given the international nature of financial institutions today?

Mr. CORRIGAN. Again, I think there is a benefit, and I think it is a historic benefit, and I think it has validity even today. That is that within reasonable bounds and limits, the dual banking system has contributed importantly to the evolution and change and innovation in the system as a whole. So I value that. I still value it. I still think it is important.

Senator WIRTH. Give me three examples of that. People always refer to it.

Mr. CORRIGAN. I think the most graphic example one by far, of course, is the NOW accounts. Delaware has taken steps to accommodate the international banking and bank credit card activities. The International banking facility arrangements that were created in New York back in the early seventies, when there was such concern about off-shore markets sapping dollar-based international activity out of New York as a financial center, is another example.

But, you do get the question of how you balance these things. For example, there are several States, who, I think, right now would go, and they may have already gone a good distance, in permitting banking organizations to get into the real estate development business. And as I mentioned earlier, this is something I worry about.

So the question arises, how do you reconcile the presence of a Federal safety net, not just deposit insurance, the whole ball of wax, with a State banking environment in which the State is permissive of activities that at least one Federal official—maybe I am not the only one—worries about.

Senator WIRTH. Jump to my third question, if I might. In October in Tokyo, you said, is there a point where the extent of foreign banking presence in U.S. markets could give rise to public policy concerns about such presence? Then you came around and started to answer your own question by saying, in my judgment, the candid answer to that question is, yes. Such concerns, particularly in the context of any pattern of future behavior which might be used by some as an aggressive strategy of expansion through acquisition.

In your judgment, would the type of progressive financial modernization that you discussed in your testimony today strengthen the ability of our financial institutions to hold on to markets in our country? In other words, to be more competitive around the world, and what are the consequences if we fail to modernize, as we are discussing today?

Mr. CORRIGAN. Well, there was a sentence a little further on there that you didn't read, that I said those concerns were likely to be more of a political nature than an economic one, but be that as it may.

Senator WIRTH. "I refuse to speculate as to whether and under what circumstances such arise, since the initial point of friction, if it ever comes to that, is likely to be more political than economic." The caveat is out on the table.

Mr. CORRIGAN. I do think that, if we were to take some steps in the direction of modernizing the system in some of the areas that we have talked about, including moving to a national banking system, I think it clearly works in the right direction, in terms of preserving and enhancing the role of our own institutions in our own country.

Senator WIRTH. Do you, in your speech, and I think it would be useful, Mr. Chairman, if we might have Mr. Corrigan's speech of October 12, where he discusses many of the international political implications, but also some very significant economic implications which you would want to discuss. And I realize we are in a political atmosphere, and it is often convenient and popular to do a little political bashing. But I think there clearly are some pretty strong economics that appear to be bubbling up more. The larger financial institutions get the larger sort of an in-house market there for U.S. computer capability and information processing and all of the technology, and if you have very, very large financial institutions favoring their own domestic suppliers in that area that disadvantages our domestic suppliers.

It seems to me that there is a synergism perhaps in all of this that appears more and more and the notion of modernization and some consolidation would appear to be one of the answers for us in the United States.

Mr. CORRIGAN. I think that's right. As you pointed out, Senator, the issues that are raised in that speech, I think, really are important. That is one of the reasons I gave the speech in Tokyo. I think they are very important.

Senator WIRTH. It is interesting, Mr. Chairman, to think about at one point we had a dual banking structure and dual regulatory structure as well, because we were concerned about differences between a major or national market overwhelming smaller State market. I think that was some of the concern as well. Now we are in something of a different situation, that if we don't get with it, we are going to see, it seems to me, stronger international markets coming in and overwhelming stronger national markets. Maybe we ought to learn from some of those in our own history.

Mr. CORRIGAN. That is a point that is quite relevant to something that Senator Sarbanes brought up before and relevant to some of the comments in my statement about the banking franchise, because one segment of the banking market that up until now has been reasonably insulated from some of these forces, is the so-called "corporate middle-level market," mid-size company market, but that insulation is not going to last forever. The forces that are working on parts of the market will work themselves into that segment of the market as well.

Senator WIRTH. Mr. Chairman, did you get all the information you wanted on the idea of trying to get a handle on the parent holding companies? I think you were verging on that when you deferred to me?

The CHAIRMAN. Not really. If you want to take it another step.

Senator WIRTH. I am struck by the fact that we have almost an anomalous situation where we have some parts of this that are regulated and some parts that are almost unregulated. We saw in the Drexel case, the movement of funds from one to the other, and are we fooling ourselves if, in fact, we believe, as you do, I think, that before you take on deposit insurance, before you take on a lot of these other changes, you have got to assure a strong independent regulatory structure. How can you have strong independent regulatory structure regulatory structure, if you have a number of mechanisms that people can move to that effectively skirt that kind of supervision? I don't understand how you can do that.

Mr. CORRIGAN. I don't see how you can do that either.

Senator WIRTH. That is all we need, Mr. Chairman.

Mr. CORRIGAN. We have broadly acceptable and working arrangements right now on the banking side, the Bank Holding Company Act. We have nothing like that on the securities side, although the Market Reform Act that this committee has already acted on, I think, takes some constructive steps in the right direction. But as it came up here earlier, Senator, while you were out of the room, there are those even now who would say, as part of this overall modernization effort, that we should get rid of even the forms of consolidated supervision that exist right now. And I have a lot of trouble with that.

Having made those points, the holding company, as an entity is unique to the United States. It is easy to say, well, what is the big deal? And the big deal is that these holding companies are not shells. These holding companies, whether it is on the banking or securities side, are both the financial and the managerial nerve center of these companies as a whole. Those holding companies are the point of access to external capital markets, debt markets, equity markets, and commercial paper markets. Abroad, those functions are conducted in the lead bank or security company or insurance company itself. And I dangled this sentence out somewhere in my statement, that I still thought what we should move in the direction of a financial services holding company, but that, if I were starting with a clean slate, I might opt for what I call the British style as distinct from the German style, European banking model. One of the reasons would be that that kind of artificial distinction between the holding company on the one hand and the true lead or dominant financial entity would be eliminated.

But I don't think we are ready for that. We will talk about that in 10 years.

Senator WIRTH. Well, Mr. Corrigan, thank you very much again for being here and for your help to the committee and to many of the members of the committee, we greatly appreciate it.

The CHAIRMAN. I want to pursue a couple more things but I don't want to trespass on your time. I don't know what your schedule is.

Mr. CORRIGAN. Fine.

The CHAIRMAN. I want to take this further, if I can.

We have seen banks get into a lot of trouble and lose a lot of money on things, in real estate. We are seeing some problems now as softness in real estate values different areas. Writedowns are going on which seem to result primarily from miscalculations on real estate values or from sharply falling real estate values. There are some prominent examples in the Northeast.

But going back a few years, we saw major losses taken on foreign loans. I am very uneasy right now about the volume of bridge loans made for leveraged buyouts. We are trying to get the information we need, but what we have right now makes me uncomfortable that there is too much of that activity out there now. And it is not just in the banking system. It is in other parts of the financial system as well.

There are other similar types of problem investments in different financial institutions. I won't get into those right now. But banks have found lots of ways to lose large amounts of money, and we have had some major collapses. Problems at Continental Illinois and elsewhere have brought the insurance fund down to about, I think, $13 billion. I hope the insurance fund isn't drawn down further. It is in the nature of banking that you can lose a lot of money in a short period of time. Even big institutions, run by very prominent people earning high salaries, can nevertheless squander an enormous amount of money.

If we are going to change the risk profile, profile of banks it will relate to deposit insurance, the safety and soundness of the banking system, the payment system, and the transmission mechanism for Fed policy.

The two have to be taken in conjunction with one another. They have to be weighed very, very carefully, especially after our experience in the savings and loan collapse.

The more this Senator thinks about it, the more the fundamental things need changes. I think we ought to maintain Federal deposit insurance, for there are certain important virtues to it. However, we want to set certain boundary lines that say that, if you want Federal deposit insurance, then you will have to stay on this playing field. If you want a playing field that is wider, then you can have it, but do without Federal deposit insurance. You do it with your own capital. You do it with private insurance, or with insurance that does not put the taxpayers of the country at risk because you will undertake a broader set of activities.

Somebody might point to this huge, new looming international dimension. We want to be able to compete in the international marketplace. We want the United States banks to prosper and thrive in Europe, Japan and other places. But we also want banks to be thriving in hometown America. We want local community-banking organizations that are plain vanilla. They collect savings, make a certain amount of investment in their community and put those savings back into the community.

Banks form a critical part of the payment system. They are the centerpiece of our national payment system. They are still the transmission valve for Fed monetary policy through the rasing and lowering of reserves. I still see that they still have a very central role.

Would you dissent from that, or do you want to——

Mr. CORRIGAN. I wouldn't dissent. I think the nature of the transmission belt has changed a bit, but I still would——

The CHAIRMAN. Oh, I would agree with that, that it's changed a bit. But banking, it seems to me, is unique in the sense that it has a bundle of functions that are very important public functions. These public functions are the reason we are here talking about it. As a public official, you have a very important public responsibilities and obligations to ensure that these functions are carried out by the banking system. Other parts of our economic system are less vital, because they are not intimately tied in with the payment system, or Federal Reserve policy. Very few other areas that have Federal deposit insurance which puts the Federal Government and the taxpayer literally goes on the line. The role is unique. The S&L case shows how important that kind of a guarantee can be.

There is a kind of public utility aspect to banking. Some bankers may not like it; it may sound like the brown shoe in the tuxedo crowd to say that. Banking is a very important public responsibility. Very important. In some ways, bankers are analogous maybe to the people that maintain the telephone lines or that maintains the public utility system. It is another essential public activity that must go on and so the Government has taken a very central role in it, in terms ultimately even of deposit insurance.

I want to make sure that in going to this brave new world, that we maintain the central integrity of these core functions that are absolutely essential to the functioning of this country, the communities, regions, and individuals throughout the country. There is a core base of activity that is absolutely critical to the proper functioning. I think, of our Nation. So we are here today with a lot of these things in place because of what we have learned from our history and our experience, and have experimented with and developed.

I don't want that to go into the ashcan, because I think the centerpiece of this activity is absolutely crucial to the long-term success of this system. As we make modifications, work around the edges, and make different rearrangements, we have to do them in a way that preserves that core of activity and that provides an iron-clad protection to the proper and sound performance of those obligations. Unless we are going to peel them out and give them to somebody else, these obligations will remain a central function of banks and the banking system. I want to make sure that those things continue to get done and get done properly.

So I start from that point, and then begin to raise all kinds of questions. You can start to test that thesis in a lot of ways. You can start in a little town in Iowa or a little town in Michigan. Somebody saves part of his paycheck, takes it to the bank. Does the bank reinvest it in the corner drugstore or manufacturing company in that town or make a student loan? Or does it buy Brazilian bonds, or something else a little more exciting, where there is a front-end fee. Perhaps the bank is being hustled by a big international money center bank, and the return looks pretty attractive.

All kinds of questions arise as to how the credit system works. Who gets the credit, how much money is to be saved and how it is spent?

I want you to understand that I am starting from a basic need and then building up from there to where we will eventually need to go.

Would you agree that these four functions, these central functions that exist today, will be there ten years from now? That this is the heartbeat of the system? Isn't that why we have the banking system? Isn't that why it is a public policy issue?

Mr. CORRIGAN. Absolutely. Again, I tried to reflect a little of that in the last section of the statement. The comments you have just made, Senator, are a rough paraphrase for that thing I wrote back in 1982. "Are Our Banks Special?" Darn right they're special, for the very reasons that you have just stated. And it is those functions that you just spoke about that make it special in the context in which the impartiality of all features of the credit system are important. There is a function that you didn't mention that everybody forgets about, and that is that the banking system and the banks are the pen ultimate lenders of last resort. And when you have a problem like October 1987, the banks are the only thing that stands between that problem and the central bank. That is a very critically important function. So, yes, those things are the foundation.

Now how do we preserve them? You say, put an iron cast around whatever phrase you used.

The CHAIRMAN. Well, no, I am saying that we need to have a modern structure that maintains the integrity and the strength of those core functions.

Mr. CORRIGAN. I agree with that. The one thing I am not worried about—and I worry about most everything, so this is a major development—is the vitality, the well-being of community banks, small, well-run institutions that provide those very special, very important needs that you spoke of.

Those institutions are going to be fine as far out as I can see. So that is not a worry, at least in the foreseeable future.

The functions, more broadly, are a worry, and that, of course, is one of the reasons why this competitive situation is so important. There's only two real choices you have, in terms of trying to preserve those functions. One is what is often called the narrow bank, where you take these uniquely particularly important functions, and you stick them in a narrow bank that can only do a very limited number of things and can only have a very limited number of assets—Treasury bills or something, and you say, that takes care of the problem.

The difficulty, and I have thought about this a great deal, is that although it is a very intellectually intriguing idea, I don't see that it is practical. It might, for example, take care of the payment system issues as they pertain to retail checking accounts, but I'll be darned if I can figure out how it takes care of——

The CHAIRMAN. Well, let me make it a very practical issue for you. If you start to add things on to the narrow bank, the narrow bank becomes a broader bank and a still broader bank, and, you stretch deposit insurance at each stage along the way.

And the question is, how far do you stretch deposit insurance out before you say I don't want to take the deposit insurance any further. I don't want to insure that next round of activities.

Mr. CORRIGAN. Right.

The CHAIRMAN. We have got a growth mentality ingrained in our society. If you are not growing, if you are not increasing your profitability, if you are not increasing your market share, if you are not increasing your price-earnings ratio, you are a failure. That drives a lot of what goes on in the financial markets. Growth for growth's sake is almost a religion. I'm not here to argue against economic growth and real growth, because growth is the key to our future.

On the other hand, I don't think being big for the sake of being big necessarily yields better results. There are just as many cases that show that big eventually falls in on itself. The synergies of an even more complex conglomerate that is into everything under the living son, gets harder and harder to describe and examples harder to find. Forget banking for the minute, there is a point of diminishing returns beyond which you start to integrate too many activities under a single umbrella.

How far out do we take deposit insurance? And is there a point after which you have to shear it off and say, if you want to do this, whether it's investing in junk bonds or something else, do it with private capital. You can do it with private capital. To the extent you can attract private capital, well and good. I'm not going to be a party to that kind of an arrangement where Federal deposit insurance stands underneath acting, as a crutch or as a conveyor belt for traditional savings—or even brokered deposits. This is one of the things we have learned in the past, especially with the abuse of state powers. You find that 70 percent of the losses in 1988, in the savings and loan system, came in two States. Seventy percent of the total national losses came in two States, Texas and California, with wide open State charters. Most of the losses were in State-chartered institutions.

So the whole question is how far we are going to stretch Federal deposit insurance out. I'm not talking about just state powers and dual banking. I am talking about adding to the risk profile and inviting funds that are government insured into new activities that contain a different—a very different element of risk.

Now one of ways we deal with that pollen is risk-based capital standards. You say, look, if you want to get into this kind of a profile, then you got to jack up your capital, you got to have more private capital at risk.

What I'm saying is that I'm uneasy about bigness, in the name of diversification, in the name of global size and market share, when it is going to be underwritten by deposit insurance.

Is there not a point at which you have to disconnect the Federal deposit insurance and retain it for activities? Beyond that point, you are on your own, you have got to use private capital, and you not risk the taxpayer. You have made that point over and over. You are one of the few people in the country that makes that point and who is concerned about it and expresses it. If you have a systemic collapse, you have a collapse in the banking system—a problem that is an order of magnitude more difficult to resolve.

We went through that problem 50 years ago. It is not a situation that we should risk recurring.

Mr. CORRIGAN. Again, Mr. Chairman, I think the question that you are raising is the right question. Now how far do you go? And how do you know when you have gone far enough? It is precisely for that reason that I suggest in this statement today and other forums that you have to look at the whole picture. If you say today, we are going to extend banking activities to X, Y and Z, and we are not going to do anything else in terms of supervisory issues, possible reforms of the deposit insurance system, et cetera, I would say, wait a minute.

On the other hand, if you say, as a part of a package, here is what we are going to do. Different ballgame. If you say to me, as a part of a package, we're going to do this in a context in which the capital position of the institutions under question is X, as opposed to Y, and therefore, the potential risk to the deposit insurance system and to the taxpayers is that much lower, different ballgame.

So I think your question is the right question. I have tried to suggest ways of getting at that question, but this is a very important distinction. You've got to be careful that, in the interests of preserving and enhancing the financial underpinnings of the deposit insurance system, we don't leave ourselves vulnerable to other problems that can wash back on the deposit insurance system through the side door or the back door.

For example, allow a large systemic disruption to occur someplace out here away from those core banking functions, away from the deposit insurance system, because we said to ourself, "Well, we don't have to worry about that, because its all being taken care of with private capital," we could still have a systemic shock of considerable dimension that could wash up on the deposit insurance system and on those hallowed functions in a very, very vicious way.

So again, the judgments about where you draw the line are very important, but we got to be careful that once we draw those lines, no matter where we do it and how we do it, we don't delude ourselves into thinking that other stuff is irrelevant, because it won't be.

The CHAIRMAN. What percentage of the current banking assets in the country today are held by foreign banks here?

Mr. CORRIGAN. Measured in terms of assets, about 24 or 25 percent.

The CHAIRMAN. Now, just for the record, indicate what that means.

Mr. CORRIGAN. Well, what it means is that something like $1 in $4—the number is not that precise—something like $1 in $4 either on deposit or in asset forms in U.S. banks are in banks that are either—well, that are controlled or owned by foreign banks. About $1 in $4.

The CHAIRMAN. Yes. What would the percentage have been, say 10 years ago?

Mr. CORRIGAN. One in 10 percent. That is a guess.

The CHAIRMAN. So maybe 10 percent.

Mr. CORRIGAN. Yes.

The CHAIRMAN. So it has grown quite substantially in a fairly short period of time. It's now up to 24 percent or thereabouts.

I am told that the percentage in California is even higher. That if you start to look at it State-by-State.

What if it goes to 50 percent?

Mr. CORRIGAN. That's a hypothetical question.

The CHAIRMAN. I am posing it that way. Does it matter if it does?

Mr. CORRIGAN. As I have said, there is a point where something like that could matter. I don't know where that point is. The Commonwealth of Puerto Rico has a banking system where, I think, the foreign banking presence, if I am not mistaken, is over 50 percent, and they seem rather content with that. So I don't know that you can answer it in terms of a number.

The CHAIRMAN. If I may say so, respectfully, Puerto Rico is a unique situation. It is a commonwealth. It's got 936 tax status. I mean, there are all kinds of reasons why the United States cannot function the way Puerto Rico functions. There is 50 or 60 or 70 percent of banking done by international banking interests is no problem. I don't think you want me to draw that conclusion here.

Mr. CORRIGAN. I want you to draw the conclusion that I cannot tell you under what circumstances there might be a problem. I cannot answer that.

The CHAIRMAN. All right. Can you or your people at the New York Fed give me a sense as to how rapidly that percentage is growing and when it might reach 30 percentage points or 35 percent? It is increasing, is it not?

Mr. CORRIGAN. It has been increasing; that is correct. To answer that question, you've got to tell me what we are going to do with our budget deficit, you've got to tell me what we're going to do with our current account deficit, you got to tell me what we are going to do with banking legislation. You answer those questions, and I'll answer your question. I can't answer it in a vacuum.

The CHAIRMAN. All right. Fair enough.

If the banking opportunities in this country look so bleak, why is it, that foreign bankers are showing up to do banking in the United States?

Mr. CORRIGAN. I think that the fundamental reasons are partly historic. Foreign banks first came into this country in a significant way much earlier, and part of that was in the context in which banking markets were different than they are, but basically, I think they are driven in part by trade in goods, and partly, I think, because, as I said in the end of this statement, whatever else we may say, our financial markets still are today the bellwether of the world's financial markets. So if you are going to function well on a global basis, you've got to have, at least right now, an important presence here. In the case, for example, of the Japanese banks, all of their activities in Latin America were undertaken through U.S. offices because of the geographic proximity.

It is also true, as I mentioned in the speech that Senator Wirth referred to earlier, that because of differences in cost of capital and things like that, they can operate here in the context in some cases of spreads and margins, which are still quite attractive in the context of the returns that they can earn as a whole.

So it is a broad selection of reasons, but a lot of them come down to hard economics, and a lot of them come down to soft economics.

The **Chairman**. Those are sensible points that you make. But they obviously don't see banking opportunities in the United States to be unattractive, because they are here in a major way and they are growing.

Mr. **Corrigan**. The great part of what most of these foreign banks do in the United States is in internationally oriented wholesale markets, securities markets type activities and that type of thing. They are not, by and large, with the possible exception of one or two cases in New York and one or two in California, they are not in—certainly not in the retail banking business.

The **Chairman**. But even if they're not, why won't they, over time, get into retail banking?

Mr. **Corrigan**. Well, maybe they will.

The **Chairman**. Isn't it logical to assume that they will?

Mr. **Corrigan**. Maybe they will. But so far, the number of foreign banks that have made inroads in foreign retail markets is very, very, very limited. We have a couple of cases here in the United States, a couple in Europe. Right now, Citicorp, to its credit, seems to be making some genuine inroads in retail banking markets in Japan. But the number of cases where we have seen that strategy work successfully are very limited.

The **Chairman**. If you leave aside financial services and look at other areas in the economy, you will see a pattern where foreigners are doing quite well particularly in heavy manufacturing. They are establishing plants here and running under their own names. So I think it is logical to assume that that's what we will see later on.

But let me move to one other question I want to raise with you. Should we do away with the Bank Holding Company Act that prevents major industrial companies from combining with a major bank.

The Ford Motor Company, a major industrial company, certainly, the second largest in the Fortune 500 list, has now a very major presence in the savings and loan business with its First Nationwide chain.

Is there something different about the savings and loan business, as it now is defined, and compared to commercial banking that causes you to have more concern about additional activities done in commercial banking industry than in the savings and loan, industry? Can you differentiate between the two?

Mr. **Corrigan**. If I had my druthers, I wouldn't differentiate. That's being a purist about it. As a practical matter, it seems to me that we may have to accept the notion that, if it is a thrift in the old sense of the word, a thrift which passes a rigorous asset test of home mortgage lending, then maybe you grandfather. In principle, I find that distinction rather artificial, but I could live with it.

The **Chairman**. Well, just to pursue it for a minute. Ford Motor Company is quite content to be in the new and scaled-down, less exotic savings and loan business. They frankly say so. They think it is a good business, they like it as an adjunct to their other activities. They think that a well-run operation, narrow in scope. We certainly narrowed down the scope of the savings and loan industry with the legislation. They think it is a good business, and they are not pressing for new powers.

Can we go further? Can we have differences about whether or not to dismantle part of the Bank Holding Company Act? Even though you don't like the idea and I am not sure I like it either, can we let a large nonfinancial institution under a holding umbrella, a sizable commercial bank? Does the decision depend upon what that bank does?

Mr. CORRIGAN. Well, I think there are two issues here. One has to do with motivation. Why does company X want to own and control institutions that have access to the so-called "safety net"? And again, I can only think of three reasons that are possible as to why.

The first would be that they perceive that the rates of return on that investment are higher than the rates of return on alternative investments, and all they are really interested in is a totally passive investment, because the return is so great.

That's one possibility. A second possibility is that they see some form of powerful synergies between that company X and this financial firm that has access to the safety net.

The third motivation that is possible is that they want to use the institution to get access to one or more aspects of the safety net, whether it is the payment system or whatever.

Now I can't think of any other reasons but those three.

The CHAIRMAN. Let me give you another one, related but not identical to your second one. This may not prove to be a wise decision in the long term. But Ford Motor Company today is a very well-run, very thoughtful company. They are quite satisfied with the move they have made, and they think it is a sensible one. And they have done it not for synergy as you might traditionally think of it, but for diversification. They like to have a business base where one component part is different from the others and maybe counter-cyclical. It might institute a solid piece of a larger company, where the earning stream is more traditional, more conservative, and more dependable within some varying range.

So I think they have seen it as a business that——

Mr. CORRIGAN. I would, myself, put that more in the first category of things, rate of return over time, stable, low beta coefficient, whatever.

The CHAIRMAN. I don't know that you can justify the decision on rates of return alone, because they are lower. It is really a different kind of an argument, concerning what constitutes the scope and scale of a business entity that can compete internationally.

Mr. CORRIGAN. That's right.

The CHAIRMAN. This is a big international company.

Mr. CORRIGAN. You can put it in the second category. In my mind's eye, I always thought of that as part of the first, but it doesn't matter where you put it. I agree that it can be a subset of either one or two of the three sets of motivations that are raised.

Just going on from that for a minute, if the motivation is either two or three, as I have defined it, by definition, that presupposes that the owning company has more than a passive influence on how that second level company operates. That has to be true. That's my problem.

In addition, it seems to me very, very clear that, even if we could get ourselves or at least get myself over that hump, I would say, and I think you would say; "OK, maybe we can live with this," but we are going to have to have some kind of an approval mechanism, and we're going to have to have some kind of regime that says Ford Motor is OK, but Supporto Offshore Oil is not.

And of course, the problem that as soon as somebody sprinkles holy water on one of these marriages, and casts aside the other, the safety net is extended. I keep coming back to the question: What is the compelling public policy reason why we should do it? What do we get out of it? And that is where I get a little stuck. The difficulty is that, if you say it's OK for company X, whoever that may be, because they're talking about this nice, neat, little sleeper over here, what happens when it's company Y, and the thing ain't so nice and sleepy? How do you live with the precedent?

So I don't want to seem, Senator, to be unreasonable, and I certainly don't want to seem as though I am digging my heels in on a position simply because I have taken it in the past. I have thought about this seven ways to Sunday.

The CHAIRMAN. Is it fair to conclude from what you have said today and what you have presented to us, that in the end, whatever we do to change the nature of the banking system, that it ought to be related back to, to use your phrase a minute ago, compelling public policy.

Is there any reason to do banking deregulation or banking modification or banking restructuring for reasons other than compelling public policy reasons?

Mr. CORRIGAN. No, so long as you define both sides of the compelling public policy. I would define public policy in a broad setting. In other words, you have to consider what happens if you do nothing and whether those results are in the public interest?

The CHAIRMAN. No, I understand what you are saying, and I agree with it, but I am making a point that banking is different from a lot of other elements in our private sector economy.

Mr. CORRIGAN. Again, I think I have made that point today in the statement. I have made it time and time again in the past. On that one, you are preaching to the choir, Mr. Chairman. I couldn't agree more.

The CHAIRMAN. I stress it one more time. In today's psychology, in what is left of the "roaring eighties," the psychology that is spilling over into the nineties, there is a drive for banks and commercial companies, to get larger, to become more profitable, to succeed, and to get more market share. People's performance is judged and rewards allocated based on such yardsticks of performance. That driving force has become universal across our economic system. So it is not surprising that it exists in the banking system.

At times, the drive for size and the drive for growth, the drive for profits, the drive for market share, the drive for a higher and higher and higher level of success leads an individual company into opportunities that run smack into the compelling public policy reasons for which the banking system and Federal deposit insurance exist. When talking with bankers, I sometimes find a banker who is well rooted in the compelling public policy ground. But then I talk to other bankers who never mention it. It may be in the back of their mind, but has gotten unhinged in their argument, as being archaic and not terribly relevant to succeeding in the modern marketplace.

How we reconcile these things today is not easy. The push is onward and upward and outward. Reconciling that drive with compelling public policy is a complex dilemma.

I don't know if you want to make—you were looking——

Mr. CORRIGAN. I was trying to find the right page. Pages 41 and 42 of this statement that I gave you this morning, I think speak very directly to those issues.

The CHAIRMAN. You have been very patient today. There are some questions for the record that we have developed. We would like you to respond to them with the same spirit of the care with which you have developed your proposal.

Mr. CORRIGAN. Sure.

The CHAIRMAN. I don't want to take the time—and your time also—to go through them here now. I would very much appreciate if you would take a look at them and give us, if you will, your response for the record to a list of additional questions.

Mr. CORRIGAN. Sure.

The CHAIRMAN. There are some other members, who I think will do the same.

Again, I want to thank you. You have been very patient and always forthcoming to us and very helpful.

Mr. CORRIGAN. Thank you, Mr. Chairman.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

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E. GERALD CORRIGAN
PRESIDENT

June 12, 1990

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Riegle:

In conjunction with my testimony before your Committee on May 3, I am enclosing my responses to the written questions on modernizing the financial services industry that Senator Dixon, Senator Sasser and Senator Graham recently sent me. I hope that these answers are responsive to the issues that they have raised and permit the hearing record to be closed in a timely fashion.

Whenever I can be of further assistance to you or any members of the Committee, please let me know.

Sincerely,

Enclosures

Response to Question from Senator Dixon

Q. During the May 3 Hearing, Senator Dixon requested Mr. Corrigan's views on S. 305, the Proxmire Financial Modernization Act, which passed the Senate last session.

A. At the outset I should say that I agree with the broad thrust of S. 305 -- the Proxmire Financial Modernization Act -- and, particularly in light of the support this bill has received from the Senate, I believe it is a good vehicle from which to debate the complexities of financial service reform.

I would like to reiterate my support for broadening bank holding company powers to permit ownership of full-fledged securities affiliates. I support the concept of a diversified financial holding company and consolidated supervision by the supervisor of the predominating financial subsidiary, although I would prefer to move towards consolidated supervision immediately rather than wait for the Board and the SEC to study the matter for a year after enactment. Finally, as you know, I strongly support continuing the separation between banking and commerce.

A brief word about the firewalls, which is an issue I discussed at some length in my May 3 statement. Back in 1987 when the Financial Modernization Act was originally introduced, the Board had begun looking at the existing bank holding company structure with an eye towards expanding the permissible range of nonbank activities. Generally, the Board favored an incremental approach which permitted bank holding companies to engage in new securities powers in the most prudent fashion possible. The firewalls were considered an essential component of this approach.

Since 1987, bank holding companies and the Board have gained valuable experience with expanded powers. It is therefore appropriate at this time to step back and reflect upon the desirability of the many inter-affiliate restrictions associated with these activities. Because the Board has before it two applications to modify the firewalls, I am unable to comment on these matters specifically. However, I can say that I believe that Chinese Walls, which prevent conflicts of interest and discriminatory practices, are a necessary component of any supervisory scheme. I can also say, in a general way, that I am less enthusiastic about many of the other firewalls, particularly those that totally prohibit affiliate lending. Again, I think it will be productive to review these issues in the light of the experience and knowledge gained over the last few years, and I look forward to participating in this inquiry in any way my position permits.

Regarding the issue of powers granted to State banks and State bank subsidiaries, I appreciate the benefits of the dual banking system but I am concerned about the possibility of Federally insured institutions engaging in activities that Federal supervisors view as too risky. It is important to strike some kind of balance between these competing objectives.

The bill provides for limited grandfathering of both nonbank banks and insurance powers. As a general rule, I favor either transitional or permanent grandfathering as opposed to immediate divestiture.

Responses to Questions from Senator Sasser

Q.1. I hear with increasing regularity about a credit crunch that's developing in the country. In particular, there seems to be a problem in my home state of Tennessee. The story I hear is that because of over zealous examiners, banks are not lending to qualified, solvent borrowers that they have lent to in the past. Banks are being forced to reserve against existing loans that they consider to be sound. The banks say that the examiners are overreacting to problems in the recent past -- namely the savings and loan debacle.

a. Certainly, we don't want to repeat the mistakes that were made with thrifts. However, is there a problem of credit drying up?

b. Not only the real estate sector, but also small businesses are complaining that they can't get credit. What do you think?

A.1. I very much share your concerns about the possibility of creditworthy borrowers -- large or small -- not having access to credit. For this reason, we in the Federal Reserve have been monitoring conditions in credit markets very closely in recent months. Those monitoring efforts suggest several things. First, we do not see evidence of a systematic or generalized curtailment of credit availability. Nevertheless, in some geographic markets and in some classes of lending -- notably for real estate development -- there has been a slowing of credit growth. Where that is the case, it appears to primarily reflect regional economic conditions and/or the presence of an oversupply of newly developed real estate projects, both commercial and residential. Second, statistical and survey data suggest some moderation in credit growth but they do not indicate any symptoms of a "credit crunch". Finally, discussions with a broad cross section of lenders -- including those associated with the small business and agricultural communities -- do not suggest patterns of behavior that are out of line with those suggested by the statistical data, even though such discussions do indicate some firming of credit criteria.

I recognize that this matter is of continuing importance. Accordingly, we will continue to monitor the situation carefully in the period ahead.

Q.2. Proposals to restructure the financial services industry seem to be breaking down into two camps. Some of the plans emphasize so-called firewalls that would be a buffer between the federally-insured bank and the non-banking affiliates, but with no regulation of the holding company. Another group espouses oversight of the holding company umbrella by some super regulator, and doesn't place as great an emphasis on firewalls. I would place your proposal of two years ago in this latter category.

a. What do you think? Which is more important: holding company regulation or firewalls?

b. Is it necessary to have a regulator that can look at both sides of a transaction between a bank and its affiliates, or is a strict prohibition enough?

A.2. a. Since the holding company is often the financial and managerial nerve center of the corporate entity, consolidated oversight of any financial company with access to the "safety net" is essential. In contrast, firewalls cannot always isolate troubled affiliates from healthy ones. Case after case illustrates that when liquidity and other problems affect an affiliate, those adversities do not respect firewalls. In addition, firewalls may prevent the corporate entity from exploiting the synergies that motivated such affiliations in the first place.

b. Consolidated supervision of the whole and functional supervision of its parts are needed to ensure safety and soundness and compliance with all laws and regulations. Since the effectiveness of strict prohibitions on certain transactions will depend in large part on the effectiveness of supervisory oversight, simple prohibitions are no substitute for consolidated supervision.

Q.3. Next year as the Banking Committee considers financial modernization legislation, we will have a multitude of proposals before us. Some will permit a bank to affiliate with any kind of a company, while other proposals will permit their entry only into businesses that are financially related. Indeed, many are arguing that these issues are almost moot, because the Federal Reserve has permitted banks to engage in a broad range of securities activities already.

a. How would you envision the future of small banks in all these proposals? As you know, several banks have not availed themselves of the opportunities presented by the Fed's section 20 decision.

b. Separately capitalized affiliates are expensive to set up. As the big banks get bigger and engage in a broader range of activities, will there be any room for small banks?

A.3. This question is in no way moot. The expansion of bank powers, including the lifting of restrictions on securities, interstate banking, and insurance activities, will benefit small banks, whose expertise in cultivating customer relationships and exploiting market niches will serve them well in the future. The brokerage/agency distribution functions for securities and insurance products are likely to complement such small bank strengths, and small banks should benefit even if these activities are conducted in a subsidiary of the bank. Smaller institutions could mitigate size disadvantages by pooling their efforts and offering these services on a joint basis. In my view, small banks will not only find room in the industry, but will flourish there.

Q.4. The May 3, 1990 Washington Post ran a story highlighting the indirect costs of federal S&L borrowing. The article indicated that massive S&L borrowing is putting upward pressure on interest rates.

a. What do you think of this analysis?

b. Is the recent rise in rates due to an increased demand of the government for credit, or is it some other influence, like the Fed's open market activities?

A.4. In my judgment, the recent rise in interest rates was in large part due to two factors, both of which appear now to have been reversed. First, the bond market was concerned about an upward trend in inflation. Late last year and early this year, prices went up mainly, though not entirely, because of weather-related rises in oil and food prices. Subsequently, however, pressures in both sectors have abated. Second, some of the economic data turned out to be stronger than many had anticipated, but more recent evidence suggests that growth is continuing at a generally modest and sustainable rate. Interest rates have moderated as these developments have become clearer. I would judge that Federal borrowing related to the S&L problem has been only a very minor factor, at most, in recent rate movements.

The global demand for savings, of course, remains very great. The needs of the emerging democracies of Eastern Europe and Latin America will compete with the elevated level of U.S. public sector borrowing, exerting pressure on overall levels of interest rates.

Q.5. Next year, this committee is going to plunge headlong into the question of deposit insurance reform. One of the big issues will be whether or not we should continue the policy of too big to fail.

a. What about the question of too big to fail -- do you think the legislation that we move through this committee next year should contain provisions eliminating this regulatory policy?

b. Are there any major institutions in this country that would be in danger of failing if we get rid of this policy?

c. Could the FDIC handle large failures?

A.5. Since both the Treasury and the Federal Reserve are currently analyzing deposit insurance reform proposals, I would prefer not to discuss the specifics of various reform proposals at this time. More generally and as I emphasized at some length in the final section of my testimony, the deposit insurance system must be looked at in light of the safety net as a whole. The philosophy which guides our thinking about the safety net and its relationship with the structure and stability of the banking and financial system is, at the end of the day, the key to a satisfactory resolution of this question.

Responses to Questions from Senator Graham

Q.1. IMPACT ON U.S. BUSINESS DOING BUSINESS OVERSEAS: Because of your position you are aware of the competitiveness factors facing U.S. financial institutions from European and Asian financial institutions. Are you also aware of any changing financing trends U.S. businesses are making when they do business overseas? Are they going to foreign financial institutions more than they have in the past? If so please explain.

CREDIT RATING AND IMPACT ON U.S. BUSINESS: A recent article in the American Banker from April 27th entitled "American Banks Seen Losing Edge" says "U.S. banks' low credit ratings could destabilize the international financial system and cost the banks market share in this country and abroad, Robin Monro-Davies, managing director of IBCA Ltd. has warned. "The differential is profoundly worrying. If (U.S.) banks, as financial intermediaries, become regarded as inferior credits, they will no longer be regarded as safe places to keep money - and the rationale for having them begins to disappear." What impact will this have on U.S. businesses?

A.1. Foreign banks serve a growing portion of U.S. businesses' overseas financing needs: the U.S. non-bank sector owed $154.4 billion to non-U.S. offices of foreign banks at year-end 1989, up 220% since 1984, while it owed $24.7 billion to foreign branches of U.S. banks in 1989, up only 14% since 1984. By comparison, commercial and industrial loans by U.S. banks to U.S. addressees totalled $491.8 billion in 1988, up only 18.2% since 1984. These debt figures do give rise to some concerns. Further increases in U.S. overseas borrowing from foreign banks may leave U.S. borrowers more sensitive to credit market disturbances abroad. In addition, the above data may reflect a loss of influence and a weakening in the international competitive position of U.S. banks. However, U.S. financial firms continue to provide many other services to U.S. firms overseas. Over 1984-1988, for example, U.S. banks and securities firms were primary lead managers for 62% of all dollar-denominated Eurodebt issued by U.S. borrowers.

Q.2. STRUCTURE:
Harry Walsh, Under Secretary in charge of Financial Institutions and Markets Group from the British Treasury, said recently at a meeting that the United States should shift its focus on the way we look at structure questions from "who sells" what products to "who buys" the products. What do you think about that perspective?

A.2. There is something to the notion of looking at the structure question from the perspective of "who buys" if for no other reason that the obvious fact that the "buyer" determines the demand for the product or service in question. In the case of banking and financial services, the multiple choices available to the buyer -- especially high credit quality business establishments -- is one of the key forces that is working to undercut the value of the banking franchise that is described in some detail in my May 3 statement.

Q.3. COMMERCIAL COMPANIES:
Starting on page 32 of your testimony you discuss the fact that you still have a "discomfort about the nature and extent of the 'banking-commerce' linkages that the German-style universal bank seems to imply." In fact on page 34 of your testimony you say that "there are three areas in which my personal views may place me somewhere between a distinct minority and a voice in the wilderness -- probably closer to the latter." (Regarding 1. a system of consolidated supervisory oversight of any company that has direct or indirect access to the "safety net;" 2. merging of banking and commerce and any arrangements that would even remotely contemplate the ownership and control of bank holding companies or financial services holding companies containing depository institutions by commercial concerns; and 3. firewalls becoming "walls of fire.")

Also there was an article from the Financial Times on April 27th entitled "American Express to Open Canadian Banking Arm." "Its aims are to give 1.5 million American Express cardholders in Canada access to the 8,000 automated teller machines operated by other members of the Canadian Payments Association and secondly, it plans to issue cheques to cardholders who have taken out lines of credit."

Why are you the "voice in the wilderness" when it comes to commercial companies owning a bank?

What do you think about the Canadian approval for this kind of ability for American Express?

A.3. The American Express case should, in my judgment, be looked at in the light of the Financial Services Holding Company Model. That is, given some reasonable definition of the scope of activities that a Financial Services Holding Company could engage in, my hunch is that American Express would qualify as such an entity. If that were the case, under the approach I have suggested, it could own and control one or more banks in the U.S. -- something it already does abroad.

My comment about being a "voice in the wilderness" on the banking-commerce issue obviously involved a bit of linguistic license reflecting the fact that there are many influential figures who take the opposite view. The reasons for my position are spelled out in my statement before the Committee.

Q.4. SMALL FINANCIAL INSTITUTIONS:
What future do you see for small financial institutions?

A.4. There is no question in my mind that small financial institutions -- including community banks -- will continue to flourish as far into the future as I can see, irrespective of what changes are made in our banking and related laws. Because of the nature of their relationships with their customers and because of their ability to specialize within their respective market niches, these are the institutions that still have considerable franchise value. And, experience -- such as the advent of statewide branch banking here in New York and New Jersey -- clearly shows that these small institutions are more than able to hold their own even in the face of direct competition from the largest institutions. Thus, while we surely will see some consolidation in banking, small well-managed financial institutions will remain a major force on the scene.

Q.5. FIRREA:
Please share any comments you have with us on how you think FIRREA is shaking out regarding:

- businesses' ability to get capital from financial institutions.
- impact on the housing industry.
- impact on banks.

A.5. As a general matter I believe it is too early to pass any judgment about specific features of FIRREA except to say that its broad thrust is working in the direction of a higher degree of discipline and vigilance in banking and related markets. However, the legislation is so complex, and its initial impact comes in a timeframe in which so many other forces are working their way through the system, that it is not possible to draw more definitive conclusions at this time.

REMARKS BEFORE THE
A.F.I.I. AND C.B.I.U.S. CONFERENCE ON
JAPANESE DIRECT INVESTMENT IN THE UNITED STATES

TOKYO, JAPAN
OCTOBER 12, 1989

BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

Good afternoon ladies and gentlemen; I am pleased to be able to participate in this most important and timely discussion of Japanese direct investment in the United States with emphasis on developments in the financial sector. Allow me to say at the outset that the views I will express today are my own and should not be construed as necessarily reflecting the official point of view of the Federal Reserve as a whole. Before turning to the particulars of developments in the financial sector allow me to begin with several more general observations which I believe can provide some perspective on the discussion which will follow:

> First; patterns of direct foreign investment and international capital flows more generally must be viewed in the context of bilateral and global patterns of national savings and investment rates as well as patterns of current account positions. That is, for a country like the U.S. which is running large internal and external deficits, the external deficit must be

financed by some combination of direct and/or portfolio investment flows from abroad. Thus, so long as there are large imbalances in these macro-economic relationships there will have to be -- as a matter of simple arithmetic -- corresponding capital flows and swings in net foreign investment positions among countries. The bilateral relationship between Japan and the United States is no exception to the inevitability of this arithmetic. It follows, therefore, that the only way the rise in net foreign investment in the United States can be ameliorated is in a context in which underlying economic imbalances are reduced over time. As in most things, at the end of the day, the economic fundamentals are what really count.

Second; as a general matter, the free flow of capital and investment across international boundaries is a clear plus for national economies and for the global economy as a whole. Free and efficient flows of capital on an international scale help to (1) promote more open, competitive and efficient national economies; (2) better allocate savings and investment on a global basis; and (3) may even help to promote greater harmony among nations. Looked at in this light, Japan is in a unique position and has unique responsibilities to assist in the optimal deployment of savings, not just here in Japan, but more generally.

Third; direct investment, particularly *de novo* investment in productive plant and equipment, can play a particularly important role in stimulating competition, growth and improvements in standards of living. Indeed, economic history -- especially in the post-war period -- provides unambiguous evidence that foreign direct investment works to the benefit of all.

Fourth; all countries have some limits on the amount or nature of foreign investment they will accept within their national boundaries. Among the industrialized countries, such limits often take the form of restrictions on the extent -- if any --of foreign ownership or control of firms or industries that are associated with the production of goods or services that are seen to have national strategic importance. Often, but not always, these restrictions grow out of national security considerations. However, while all governments respect the right of other governments to limit or restrict foreign investment on such grounds, there can be significant differences of opinion as to what constitutes legitimate grounds for such restrictions. For example, over the years we have seen evidence in some countries that suggests that banking -- or at least certain core components of banking -- can be viewed as falling within the range of commercial activities having special status for these purposes. In short, there can be an exceedingly fine line distinguishing between practices and policies that are motivated, on the one hand, by legitimate national strategic considerations and by protectionist-like attitudes on the other.

Finally, in order to provide a workable framework within which individual countries and countries at large can better manage both the politics and the economics of foreign investment, many countries -- the United States and Japan included -- have come to rely on the principle of national treatment. That principle, in its simplest form, states that, subject to limitations growing out of national strategic considerations, foreign firms should have the same rights, privileges and responsibilities as domestic firms. In practice, however, the principle of national treatment is subject to many ambiguities since it is not always easy to determine whether such equality of treatment prevails even in _de jure_ terms much less in _de facto_ terms.

Partly for this reason, the principle of national treatment is increasingly accompanied by an implicit or explicit policy of reciprocity which, in effect, says that one country will be willing to provide national treatment to another only so long as the second country provides national treatment to the first. This is the philosophy which was associated with the so-called primary dealer amendment to the

> omnibus trade bill enacted in the United States in 1987. I personally, and the Federal Reserve generally, resisted that approach, partly on the grounds that a policy of "reciprocal national treatment" can, all too easily, put us all on the very slippery slope of protectionism. Indeed, this episode should serve as a forceful reminder that we all have an ongoing responsibility to see to it that policies and practices are fully consistent with national treatment and that markets for goods and services alike are open and free to all competitors, foreign and domestic.

With those general observations in mind, allow me to now turn to the financial sector in particular. What I would like to do in this regard is to provide an overview of the extent of Japanese presence in U.S. banking and securities markets and contrast that with the extent of U.S. presence in Japanese markets. That discussion must clearly take place in the context of the explosive growth of Japanese banks over the decade of the 1980s. We all know very well that any list of the largest banks in the world is now dominated by Japanese banks. We also know that the enormous growth of Japanese banks in this decade, and especially in more recent years, has, to a very considerable extent, been driven by macro-economic considerations including the high savings rate in Japan, the country's massive cumulative current account surpluses and by net changes in dollar exchange rates.

What may not be as widely recognized is the extent to which the growth of Japanese banks has occurred in international banking markets. For example, over the seven years ending in December 1988 assets booked at the foreign branches (and agencies) of Japanese banks have increased by almost five-fold. Looked at somewhat differently, there are now almost 100 branches and agencies of Japanese banks in the U.S. as well as a number of relatively large U.S. subsidiaries of Japanese banks. From still another vantage point, in the few short years between 1984 and 1988, B.I.S. statistics suggest that the share of international banking assets held by Japanese banks grew from about 23 percent to almost 40 percent.

Turning more directly to comparisons of relative bilateral U.S. and Japanese presence in banking and securities markets, the following picture emerges:

-- judging by the limited data available, it appears that the scope -- as measured by employment and capital deployed -- of Japanese securities firms' presence in U.S. securities markets is not wildly out of line with the scope of U.S. securities firms' presence in Japan.

However, even this qualitative and broad-brushed judgment must be further qualified in that it may not fully and fairly reflect conditions after taking account of Japanese firms' acquisitions of, or minority investments in, U.S. securities firms which have taken place over the last few years.

-- the presence of Japanese banks in U.S. markets far exceeds the presence of U.S. banks in Japanese markets. To be specific, there are about 20 U.S. banks with a presence in Japan. In the aggregate, these banks have about $30 billion in assets -- a very small market share by any measure. By contrast, there are about three dozen Japanese banks in the U.S. and their aggregate banking assets amount to about $370 billion. More generally, and reflecting the openness of U.S. banking markets, foreign banking institutions in the U.S. now control about one quarter of the banking assets booked in the U.S., with slightly more than half of that total in Japanese banks. Indeed, by this measure of market share, Japanese banks now have about a 14 percent share of the banking market in the U.S. And, for selected geographic and product markets, the market share of Japanese banks is still larger. Further, if the total banking activities in the U.S. of major Japanese banks were fully consolidated (that is, to include on one pro-forma balance sheet the assets and liabilities of the family of subsidiary banks, branches and agencies) six such Japanese banks would now appear on the list of the 30 largest U.S. bank holding companies and a couple would be within striking distance of the 10th largest banking organization in the U.S. While those comparisons may -- as much as anything else -- reflect the segmented structure of U.S. banking markets, they are striking none the less.

Having said earlier that macro-economic forces such as savings rates, current account positions and changes in dollar exchange rates can go a long way in explaining the overall growth of Japanese banks over the past decade, the question that naturally arises is can these same forces fully explain the very sizable relative presence of Japanese banks in U.S. markets? The answer to that question is, in my view, negative. That is, while macro-economic forces are very important, they are by no means the whole story.

For example, one can reasonably point to a number of historical or institutional factors which help explain this situation. As an illustration, Japanese banks probably developed a major strategic interest in U.S. banking markets before U.S. banks developed similar interests in Japanese markets. Similarly, elements of innovation, liquidity and diversity of financial instruments in U.S. banking markets probably provided Japanese banks with more opportunities and earlier opportunities to do more things in the U.S. than they or U.S. banks could do in Japan, notwithstanding the similarities between Glass Steagall and Article 65. Finally, it is clear that for a number of years U.S. markets were more open than were Japanese markets. Indeed, the process of significant liberalization and de-regulation of Japanese financial and banking markets is only a few years old.

But, even these historical and institutional considerations, when added to the macro-economic factors cited earlier, do not tell the whole story regarding the comparative scope of Japanese and U.S. banking presence in the respective marketplaces.

A further factor that must be considered is the market valuation of the shares of major Japanese and U.S. banks, respectively. Specifically, based on recent experience, the shares of major Japanese banks on the Tokyo Stock Exchange sell at price earnings multiples that are often in the range of 50 or more. By contrast, none of the major U.S. money center banks have P/E ratios of more than 10. This pattern raises two closely related questions; first, what accounts for the dramatically higher market-valuation of the shares of Japanese banks and, second, what implications, if any, does this have for the bilateral patterns of banking presence in the two countries?

I am not well positioned to answer the first question since stock market valuation matters are not an area in which I claim any expertise, even in the U.S. much less in Japan. I suspect, however, that some of these differences can be traced to tax, accounting and regulatory considerations. The high internal savings rate in Japan may also be relevant in that the pool of funds available for investment in equities is so large. It is also widely stipulated that Japanese equity market valuations provide a significant premium for unrealized capital gains on real estate and equity holdings. In the case of the Japanese banks, these unrealized capital gains on equity investments are large in part because some of the investments they represent were seed money for industrial companies in the immediate post-war period that have since grown to become industrial giants on a national and global scale. (It should be noted that equity investment limitations governing investments by Japanese banks in industrial companies are technically now quite similar to those prevailing in the U.S.)

Whatever the precise factors accounting for the very high P/E ratios for Japanese banks relative to U.S. banks, the more important question in this context is does it matter in terms of the competitiveness between Japanese and U.S. banks? The answer to that question is yes, it does matter, and it may matter a lot. There are at least three reasons for this. First, even in the face of broadly similar international bank capital standards, it is obviously cheaper -- and presumably easier -- for the class of banks with high P/E multiples to raise fresh equity in the marketplace. Second, it is also likely that this condition may provide room within which Japanese banks may have opportunities to price individual transactions at spreads that are lower than U.S. banks can justify -- a pattern that would not be inconsistent with the low rates of return on assets generally observed at Japanese banks relative to U.S. banks. Finally, these differences in market valuation of shares also result in a situation in which it is easier for Japanese banks to expand in the U.S. by acquisition while it is virtually impossible for U.S. banks to expand in Japan by acquisition. The economics of the price tag may therefore represent a significant barrier to U.S. banking expansion in Japan. For this reason, it is all the more important that no stone is left unturned in the effort to ensure that all barriers -- visible and invisible -- to expansion and openness in Japanese banking and financial markets are eliminated.

All of this raises still another very difficult question; namely, is there a point where the extent of foreign banking presence in U.S. markets could give rise to public policy concerns about such presence? In my judgment, the candid answer to that question is yes; such concerns could arise, particularly in the context of any pattern of future behavior which might be viewed by some as an aggressive strategy of expansion through acquisition. I refuse to speculate as to whether -- or under what circumstances -- such future concerns might arise since the initial point of friction -- if it ever comes about -- is likely to be more political than economic. However, leaving aside any such political considerations, there are other public policy issues which could arise in this context.

For example, in the U.S. concerns about concentration of economic and financial power -- particularly in the credit origination process -- have been at the heart of the national debate about banking structure for 200 years. While much of the doctrine about concentration has centered on market shares of individual institutions, it is not a major leap in intellectual terms for some to suggest that concerns about concentration should be extended to foreign banks or to foreign banks from a single country. There are also a number of supervisory and "safety net" issues that arise in this context, not the least of which are those relating to the responsibilities of the home country's central bank as lender of last resort should a sizable liquidity problem arise in a foreign country. Finally, there are also the continuing questions as to whether the second country is really doing all it can in law, in regulation and in practice to provide the same degree of openness as prevails in the first country -- again, the whole question of national treatment or reciprocal national treatment.

Fortunately the last several years have seen some major progress in containing these points of concern. The B.I.S. capital standards surely are working in the right direction even though they cannot and do not solve all the problems; the very significant deregulation and liberalization of Japanese banking and financial markets in recent years has clearly helped, even though here, too, more needs to be done; the very close and cooperative efforts between official institutions in the U.S. and Japan is also a clear plus even if progress does not always come as quickly and as smoothly as both sides would hope; finally, the recognition that both countries have a major stake in finding mutually acceptable ways to blunt points of tension has grown but, here too, that recognition is not as widespread as it could be.

In closing, allow me to return to the point where I started; namely, to again stress the mutual benefits arising from the free flow of capital internationally and to stress the importance of the economic fundamentals. The most constructive thing we can both do to check points of tension in the bilateral economic and financial relations between our two countries is to aggressively pursue policies that will wind down in an orderly way the macro-economic imbalances I referred to earlier. We all lost a good friend recently with the passing of Governor Mayekawa, a man greatly respected throughout the world for his vision and his contributions to international harmony. Not the least of his accomplishments was the report bearing his name which was aimed at encouraging basic structural changes in the Japanese economy.

Looking ahead, I know others will take up this important work just as I know we will continue to make progress in our efforts to better harmonize competitive conditions in our respective countries. I am also acutely mindful of the pressing need for substantial reform in economic policy in the United States just as I am sensitive to the need to achieve a still higher level of cooperation and coordination in policies and practices that relate to the structure, operation and supervision of our banking and financial markets. None of this will be easy, but the stakes for us and for the world economy are so very large that we have no choice but to find the will and the way that ensures success.

Thank you.

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

THURSDAY, MAY 17, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Graham, Wirth, Bryan, Heinz, and D'Amato.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order. And let me welcome all those in attendance this morning. We have some very distinguished witnesses with us here today. And we welcome them and appreciate their willingness to appear and share their thinking with us.

I will introduce the witnesses after I make an opening statement to set the framework for today's discussion.

We're here this morning to take a closer look at the issue of changes in the deposit insurance system.

Federal deposit insurance is 57 years old and, during its first half century, I think it's fair to say that it attracted little attention and even less criticism.

After the Great Depression was over, few banks failed in this country over most of that period. Insurance premiums were low. The banking system was widely regarded as solid and stable, and deposit insurance was hailed as pretty near a complete success.

But, more recently, the picture has been changing. FDIC insured banks have failed in increasing numbers. For example, there were only 31 bank failures during the whole decade of the 1950's, 44 failures during the 1960's, and only 76 banks failed during the 1970's.

But, when we got into the 1980's, we saw that over a thousand (1,037 banks) failed during that decade. In fact, bank failures increased every year during the 1980's from a number of 10 in 1980 to 206 last year. And failures of course have been even more numerous in the thrift industry.

One result of these failures has been a rise in deposit insurance premiums. Another result has been increasing criticism of the current system of Federal deposit insurance.

Critics, including some of today's witnesses, contend that the current system may, in fact, have contributed to the problem by weakening market discipline on insured institutions and facilitating excessive risk-taking.

They echo Franklin Roosevelt's warning that:

Federal deposit insurance could, quote, "put a premium on unsound banking." End of quote.

In response to these criticisms, a wide array of deposit insurance reforms has been proposed, ranging from modest improvements to very fundamental restructuring.

Congress has directed the Treasury Department and the General Accounting Office to study the current system and report early next year on any needed changes that they would see.

In our hearings to date, this committee has considered deposit insurance reform together with expanded powers and reform of the overall regulatory system. We are now at a point of zeroing in more closely on the issue of deposit insurance, looking at the problems in the current system and how they might be resolved.

Our witnesses this morning, Mr. Lawrence Connell, who was Chairman of the National Credit Union Administration under President Carter, is now the president and CEO of San Jacinto Savings Institution in Texas; Mr. Bert Ely, who is president of his own consulting company in Alexandria, VA; and Mr. Kenneth Scott, who is the Ralph Parsons Professor of Law and Business at the Stanford University Law School and also a Senior Research Fellow at the Hoover Institution.

We are very pleased to have you and we will go in the order in which I have just introduced you.

Mr. Connell, we will be pleased to hear from you now. We will make all of your formal statements a part of the record, and I would like you to feel free to summarize and present the essence of your views to us at this time.

Mr. Connell.

STATEMENT OF LAWRENCE CONNELL, PRESIDENT, CEO, SAN JACINTO SAVINGS ASSOCIATION, HOUSTON, TX; AND PARTNER, PRATHER, SEEGER, DOOLITTLE & FARMER, WASHINGTON, DC

Mr. CONNELL. Thank you, Mr. Chairman, and I'll do that.

Speaking as a former regulator and one whose been working in the trenches with troubled thrifts for the last 8 years, I'll try to respond to the six questions that you presented to us in your letter of invitation.

The first question was:

Should the Congress strengthen the regulators' authority to carry out early intervention?

And this concern I think arose from the experience of the late 1970's and the early 1980's—when thrifts encountered the high interest rate problem. Their loan portfolios lost value. And the spread between their earning assets and their cost of funds essentially disappeared.

The industry was essentially insolvent at the time. The regulatory authorities, instead of resolving the cases, actually lowered capital requirements, permitted special accounting techniques, and then allowed the institutions to attempt to grow out of their problem by taking on additional risk.

This came to an end in the late 1980's as the Office of Thrift Supervision began to ratchet down that whole process and made great progress in doing so.

FIRREA I think addressed the capital issues and set minimum standards that would not allow that to happen again. But, more recently, the Office of Thrift Supervision, under its regulatory bulletin 3(a)(1), I think has addressed the issue of additional risk during the resolution period by putting very strict controls on weakened institutions.

The banking agencies also have addressed this quite directly. And you see that evidenced by the prohibition on dividends, the Federal Reserve prohibiting dividends from banks, the Office of the Comptroller of the Currency doing the same—capital raising requirements on the institutions and limiting their activities.

So I don't really see a need for further legislation at this time. I think that we can monitor that progress to assure that risk is limited.

The second question was:

Should depository institutions be required to use market value accounting?

And I believe that market value accounting is a very important management tool to manage a financial institution. The good institutions do it today. It's not difficult to market value a mortgage portfolio. We've made great progress in developing markets for consumer loans, commercial loans.

FIRREA addressed it in the sense that, by requiring disposition of junk bonds, we saw a mark to market of junk bond portfolios quite quickly.

The problem, again, is related to the earlier one. Back in the 1970's, when these institutions were market value insolvent the accounting methods masked that weakness.

Also, the institutions engaged in trading activities, taking gains on the portfolio and leaving losses on high-cost liabilities.

The trading issue has been resolved with the OTS imposing very strict standards. But I think that, as a regulatory tool and a management tool, that market value accounting, as my statement indicates, is a very valuable tool and should be implemented.

The third question is:

Should a company that controls a bank or thrift be free to let that institution fail without making an effort to assist it?

Again, from an historical standpoint, the Federal Reserve Board has attempted to impose a source of strength doctrine from the very beginning of holding companies. In the early days by denying applications for the acquisition of a bank because the holding company itself was weak, later on by imposing an extensive examination process. And, most recently, by administrative actions and court proceedings.

Just this week, they lost a case involving the source of strength doctrine. The Office of Thrift Supervision, on the other hand, had open-ended contractual net worth maintenance agreements for many years. More recently, these have been modified to prenuptial type agreements where the institutions could be sold if the net worth fell below a certain level.

I think they've been effective. And, in fact, the institution I'm working with right now has been required to put several hundred millions of dollars the holding company has into the institution and is going through a court process, a bankruptcy process where it will be required to put in additional monies.

And I believe it would be valuable as one of the extra tools, one of the additional tools, for the regulatory agencies to have in their quiver to require net worth maintenances agreements on a limited basis, prenuptial type. And they also should be structured to withstand the bankruptcy, either through a preference or some other specific provision.

The fourth question is:

Should deposit insurance coverage be changed from the $100,000 limit?

I was a regulator when that happened and it was unfortunate. What happened is that we created a U.S. Government agency obligation with no controls. And the problem is: How do you put the genie back into the bottle?

And I think, if deposit insurance levels are to be reduced, you have to tie it to a tax i.d. number because technology just allows people to spread their deposits among many institutions.

The fifth questions is:

Should Congress adopt risk-based deposit insurance premiums?

And I'm very much in favor of risk-base deposit insurance premiums as a market discipline and as a regulatory tool. And as my statement said, when we first began at NCUA to reveal the ratings of examinations to the board of directors and then let them know what was going to happen as a consequence of those ratings, we found excellent response from the directors putting pressure on management to reduce risk..

I think, when you couple that with a cost, a dollar cost, that you get management and directors' attention. And it doesn't have to be perfect. I happen to think the Camel rating is a good start.

And so I'm very much in favor of risk-based premiums.

The final question is:

Is depository institution really too big to fail?

And in that case, I kind of look at what is the definition of failure? And if you're the director of an institution or a management and you lose your position, you failed. And that's exactly what happens with mergers, supervisory mergers, or the regulatory action of removing officers and directors.

I personally don't believe that you have to go through the enormous cost of liquidating a large institution to achieve the discipline that's necessary.

These are essentially my responses to the six questions, Mr. Chairman. I'll be happy to answer any questions you might have.

[The complete prepared statement of Lawrence Connell follows:]

DEPOSIT INSURANCE REFORM

STATEMENT BY

LAWRENCE CONNELL

PRESIDENT, C.E.O., SAN JACINTO SAVINGS ASSOCIATION, HOUSTON, TEXAS
PARTNER, PRATHER, SEEGER, DOOLITTLE AND FARMER, WASHINGTON, D.C.

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

WASHINGTON, D.C.

MAY 17, 1990

Mr. Chairman and members of The Committee, thank you for inviting me to testify before you concerning the important issue of deposit insurance reform. For the past eight years, since leaving government service as Chairman of The National Credit Union Administration, I have been working with troubled Thrifts in the capacities of an executive officer, director and attorney. Currently, I am president and chief executive officer of San Jacinto Savings Association, a troubled Thrift in Houston, Texas. There, I am working to restructure the Association to maximize the return to the Owners and hopefully to avoid or minimize cost to the federal government. I should also mention that I am a member of the Shadow Financial Regulatory Committee.

My remarks will address the following six questions presented in the Chairman's letter of invitation dated April 16, 1990.

(1) Should Congress strengthen the regulators' authority to carry out early intervention --i.e., to reorganize a troubled depository institution before it becomes insolvent? If so, how should early intervention operate?

Much of the criticism of the administration of the savings and loan industry was for the delay in resolving cases when an association became or approached insolvency. The delay began in the late 1970's and early 1980's when savings and loans were suffering the consequences of too much interest rate risk. Their asset portfolios were composed of long term mortgages and their liabilities were short term deposits. When interest rates rose the value of their long term mortgages declined and the spread between their cost of liabilities and return on assets disappeared.

Rather than quickly forcing resolution of those insolvent associations by merger or liquidation, the regulatory authorities permitted the associations to continue operating at an increasing level of risk, that was compounded by special accounting techniques and new higher risk lending permitted by State and Federal Laws in the early 1980's.

However, for the past several years the Federal Home Loan Bank Board and its successor The Office of Thrift Supervision have implemented policies and procedures that prevent a troubled Thrift from increasing its risk. Today, the Office of Thrift Supervision, under its Regulatory Bulletin, RB3A-1 tightly controls weakened institutions. On the banking side all three federal agencies have acted quickly to require banks with asset quality problems to suspend dividends, augment their capital and cease unsafe and unsound practices.

Therefore I do not see the need for any further legislation to strengthen the regulators' authority to carry out early intervention. The committee in its oversight role can monitor the effectiveness of the agencies' early intervention policies.

(2) Should depository institutions be required to use market-value accounting? What specific steps toward market-value accounting are feasible?

Today a depository institution should be managed on a market value basis as much as possible. It is relatively easy to determine the market value of a Thrift's assets when its portfolio is comprised of mortgage backed securities and single-family home mortgages. Moreover, there is a rapidly developing secondary market for consumer loans and commercial loans which will provide market prices for those classes of assets.

The importance of market value accounting arose from several factors. The high interest rate period of the late 1970's and 1980's resulted in large market losses for Thrift loan portfolios, rendering them effectively insolvent. The recording of assets and liabilities at book value masked the seriousness of their condition. In addition many Associations were actively taking gains in their securities portfolio, but not recognizing their losses. They enjoyed short term profits at the expense of their basic operating margin. The regulatory agencies have addressed the trading problem by tightening their policies. The Office of Thrift Supervision (OTS) Thrift Bulletin 41, as an example, defines a trading portfolio versus an investment portfolio. Much more progress is needed for managers to market value their assets and liabilities. Market value accounting is a necessary tool to manage interest risk, and also has application with respect to credit risk. Regulators too, should be evaluating a depository institution on the basis of the market value of its assets and liabilities. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required market valuation of purchased servicing rights. By requiring savings and loans to dispose of junk bonds, FIRREA indirectly caused savings and loans to market value their junk bond portfolios.

Market value accounting also applies to the liability side of the balance sheet. Yet, under current policy there is little recognition of increase and decrease in value of deposits. Regardless of whether the accounting profession decides to recognize market value accounting, management and regulators can, if they chose, manage their business, both assets and liabilities, on a market value basis. The use of Market Value Accounting can be a valuable tool for both managers and regulators. This method is not a substitute for normal financial statement but a supplement thereto.

Industry and regulators should be encouraged to implement a market value accounting system to provide themselves additional valuable information about the Association and industry.

(3) Should a company that controls a bank or thrift be free to let that institution fail, without making any effort to assist it? If not, in what ways should the parent company be obliged to assist the subsidiary?

For many years The Federal Reserve System has attempted to enforce its "source of strength doctrine" whereby a bank holding company is expected to provide financial strength to its subsidiary banks. This concept was first demonstrated by limiting the amount of debt a bank holding company could assume when buying a bank. It was later extended to a complete examination process and currently is represented by administrative actions and litigation claims.

The Federal Home Loan Bank Board in its regulatory role and its successor, The OTS have required corporate owners of savings and loan associations to enter into contractual net worth maintenance arrangements. These agreements required the holding company to guaranty the net worth of the subsidiary savings and loan on an open ended basis. More recently the agreements have become a limited support arrangement in the form of a prenuptial agreement whereby the Association could be sold by the OTS if the Association's net worth fell below a particular amount.

I believe the OTS contractual arrangements have been effective in requiring a parent holding company to be a real source of strength to the subsidiary depository institution. The cross guaranty provisions of FIRREA were a step in that direction for bank holding companies. I believe legislation should be enacted that would specifically empower all the regulatory agencies to require such agreements and further, that the agreement be allowed to survive the bankruptcy process.

Corporate net worth maintenance agreements do discriminate between the individual shareholder and the corporate owner. However, there were parallels in the past such as the double liability of bank stockholders under state and national banking laws. There is probably no better discipline over bank management than shareholder liability. The Resolution Trust Corporation (RTC) was able to secure a $450 million settlement from the corporate owner of Merabank because of the net worth maintenance agreement in place.

Currently, regulatory rules discourage the use of subordinated debt by limiting its eligibility as capital. The prevailing wisdom is that equity capital is the best type of capital because it is perceived as permanent capital. Actually properly structured subordinated debentures could provide an equally effective capital cushion for depositors and the insurance funds. The important discipline subordinated debt offers is removal of management and directors when a company's performance collapses. When a non depository company gets into trouble, the creditors take control after a Chapter 11 proceeding. In some cases, holders of senior securities acquire voting control when the company defaults in interest or principal payments or other covenants. The creditors then reorganize the management and capital of the company.

If bank subordinated debt capital had covenants that caused a default when a bank's equity fell to a certain ratio or non performing assets reached a certain level, the holders of that debt might be able to take over the bank and remove management before the bank's capital reached the point where the regulators were required to take action. In such cases it would then be to the advantage of the depositor and the insurance funds for a bank to have more subordinated debt in its capital structure rather than less.

Over the next few years, it appears that many more banks and savings and loans will fail. Those that remain generally will be capital poor. Therefore, the reorganization of the thrift and banking industries will be extremely difficult and, consequently, more costly for the taxpayer. It is important to explore all opportunities to reduce that cost. One reorganization technique that does not currently exist in banking law is a Chapter 11 proceeding whereby a company is reorganized as a going concern, not merely liquidated. Currently regulators and the industry struggle with concepts such as open bank assistance without a formal statutory framework with which to implement the process. Today the Federal Deposit Insurance Corporation and the RTC can only act as conservator and receiver. Disputes under receiverships are litigated in Federal Court, but outside of the bankruptcy process. The time has come to modernize the bankruptcy process involving banks and thrifts. We need a formal Chapter 11 type process to properly facilitate the several hundred billion dollars of depository institution assets that will flow through receiverships and other forms of reorganization and we need the creation of Article III type judicial structural to efficiently and effectively manage the process and provide due process to all.

(4) Should deposit insurance coverage -- currently $100,000 per depositor, with no coinsurance and no deductible -- be reduced? If so, how? Should corporate depositors be treated differently from individuals? What, if anything, should be the role of private deposit insurance?

It was an unfortunate mistake to have increased deposit insurance to $100,000. I remember when it happened because at the time I was Chairman of The National Credit Union Administration. When asked by a committee staff member, whether The National Credit Union Insurance Fund should be included I reluctantly agreed to it, and then only for competitive reasons. I cautioned the staff members that The Congress, by increasing deposit insurance to $100,000, would be creating a U.S. Government Agency obligation without any control. At that time deposits of $100,000 did not have limits on the interest rate that could be paid on them. The rationale for raising the limit was to support housing finance. The legislation was an amendment to the much larger Depository Institutions and Monetary Decontrol Act of 1980 and was not subject to hearings. This increased deposit insurance coverage spawned the deposit brokerage business. It fueled the speculative adventures of the unscrupulous people who bought small savings associations in Texas and then blew them up to billion dollar disasters. Vernon Savings Association was such an example. The problem now is how to put the genie back into the bottle. Today, technology would permit people to quickly distribute deposits among many institutions, so merely lowering the amount alone would not be an effective remedy. Instead, I would suggest limiting the amount of deposit insurance to an individual by social security or tax identification number. Corporations do not need deposit insurance protection. The use of private deposit insurance should be encouraged as excess coverage. Private deposit insurance with its variable rates will also provide additional market discipline related to the risk of investments and quality of management.

(5) Should Congress adopt (or authorize the FDIC to adopt) risk-based deposit insurance premiums? If so, how should premiums be determined?

Risk-based deposit insurance premiums are a useful market discipline. They would also provide a very useful supervisory discipline to the regulatory process, especially if they were linked to a depository institutions' CAMEL rating.

The National Credit Union Administration was the first of the regulatory agencies to inform an institution of its examination rating. We discovered that we received an excellent response from credit union directors' even when institutions went from a 1 rating to a 2 rating. Disclosing the rating, the basis for the rating and the consequences of such a rating got their attention. Imposing a financial cost to the institution would further enhance the regulators' effectiveness. Some would argue that the CAMEL rating system had no actuarial base and contained certain subjective components. It really does not matter because the formula need not be actuarially perfect. Its importance is in prompting a response from a bank's board of directors and making the board understand the financial cost of risk. Therefore the FDIC should be authorized and encouraged to institute a risk-based deposit insurance premium. The agency should be given broad discretion in setting premiums, so that it has flexibility to adjust to what it learns during its early years of implementation.

(6) Is any depository institution really too big to fail? How should regulators deal with large troubled institutions?

In responding to the too big to fail issue, it is important to understand what is meant by a failed institution. Does an institution have to be put into receivership to be defined as a failed institution? When a bank is forced by its supervisory agency to merge into another bank with the shareholders receiving only nominal value for their shares, but with no receivership involved, has the institution failed? When open bank assistance is granted with senior management responsible for the problems dismissed and new outside ownership infused, has the bank failed?

As a lesson to others, some argue that a large institution should be allowed to go into receivership and then liquidated. I do not believe this is necessary to maintain market discipline. From a managerial standpoint, as far as seniors officers and directors are concerned, a bank fails when it is forced into a merger or when the senior management and most of the directors are replaced following an open bank FDIC assisted recapitalization. There is no need for the FDIC or the taxpayer to incur the additional expense of liquidation of assets sold out of a receivership. The least cost solution should be the resolution chosen.

The CHAIRMAN. Mr. Connell, thank you very much. You have been at this a long time. It' is my understanding, while you are now in the work-out situation at one savings and loan down in Texas, that you previously have done three others.

Am I right in that?

Mr. CONNELL. That's correct.

The CHAIRMAN. I am going to ask you a little bit about your experience, too, here, as we finish up.

Mr. Ely, we'd be pleased to hear from you now.

STATEMENT OF BERT ELY, PRESIDENT, ELY & COMPANY, ALEXANDRIA, VA

Mr. ELY. Mr. Chairman, I'm pleased to be here today to testify on deposit insurance reform. I commend the committee for holding these hearings because deposit insurance reform is rapidly escalating into one of the most important issues facing the Congress today.

The high number of bank failures in recent years and the $100 billion plus taxpayer bailout of the FSLIC clearly indicate that Federal deposit insurance is not working. This should not be a surprise for it has always been inherently and hopelessly flawed.

As you, yourself, Mr. Chairman quoted Franklin Roosevelt, in his very first news conference as a President, warned that Federal deposit insurance would ". . . put a premium on unsound banking in the future."

How right he was.

Worse, electronic and financial technology are rapidly undermining the efficacy of all forms of financial services regulation. Thus, the regulatory process is less and less able to contain deposit insurance losses except possibly by impairing banking productivity and increasing the risks facing the Federal safety net administered by the Federal Reserve.

The current problems in Federal deposit insurance also are blocking a long overdue structuring of an increasingly obsolete financial services industry. Restructuring must permit new powers for banks and S&L's, powers that are now feasible with today's technology.

Congress is understandably reluctant to grant those powers if they might undermine the safety and soundness of federally-insured depository institutions.

Thus, there is a growing recognition the deposit insurance reform and structural reform must progress together.

Federal deposit insurance cannot be fixed for many reasons. The basic reason it cannot be fixed is common to all Government insurance and guarantee programs: Sound insurance mechanisms are incompatible with democratic government.

In order to be successful, insurers must discriminate between good risks and bad on an objective basis; our political system, however, is premised on nondiscrimination and equal treatment for all, as it should be.

Therefore, insurance programs of any type can operate successfully only in the private sector and without Government subsidy.

There are three major specific flaws with Federal deposit insurance. First, banks and S&L's are charged flat-rate insurance premiums no matter how soundly or unwisely they are managed. Today, the drunk drivers of the banking and thrift world pay no more for their deposit insurance than do their sober siblings.

Second, regulator timidity and the political process often delay the closure of insolvent institutions. This, of course, greatly increases the insolvency loss in these failures.

Finally, the Federal deposit insurance funds have no real capital. Their losses effectively are borne immediately by the taxpayer.

Various proposals to fix Federal deposit insurance simply will not work. For example, reducing deposit insurance coverage from the present $100,000 limit will have no disciplinary effect whatsoever. Congress will spill political blood unnecessarily in a totally futile exercise if it lowers the $100,000 deposit insurance limit.

Attempting to discipline large depositors through some sort of "coinsurance" program also will have little disciplining effect. Coinsurance is premised on the idea that the too-big-to-fail policy should be abandoned.

However, attempting to get rid of too-big-to-fail will be destabilizing to the financial system. It will actually increase deposit insurance losses and it will greatly harm the domestic and international competitiveness of American-domiciled banks because other industrialized nations will not abandon their too-big-to-fail policies.

Early closure of failing banks and thrifts is another highly-touted reform proposal. However, Congress will find it extremely difficult to enact closure rules that it can force the regulators to follow, for regulators will resist mightily any effort to constrain their actions and limit the scope of their powers.

Attempts to reform Federal deposit insurance probably will fall back on that old standby: More regulation.

However, more restrictive regulation of our banks and thrifts will turn them into narrow banks limited to investing only in short-term, low-risk assets. This will harm banking productivity by destroying the synergies increasingly possible, because of technology, between bank assets and bank liabilities.

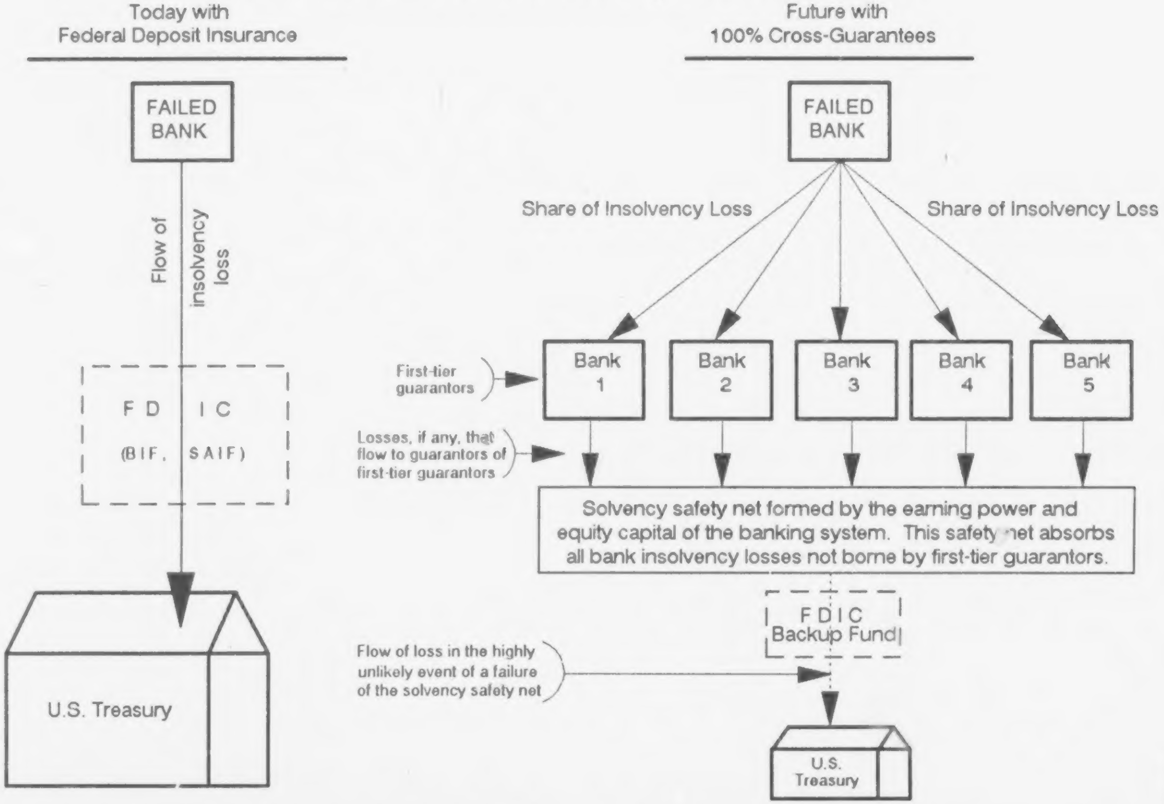
Narrow banking also will not eliminate financial risk to the economy. It will merely shift much of this risk to nonbank firms. This shift will greatly increase risk for the Federal safety net; even in a holding company context, the narrow bank is highly undesirable.

There is only one way to reform Federal deposit insurance, and that is to replace Federal deposit insurance with 100 percent cross-guarantees.

Very simply, the 100 percent cross-guarantee concept is a self-insurance mechanism for the banking system. My first chart (exhibit 1) contrasts the present system with 100 percent cross-guarantees. This chart shows how ad hoc syndicates of banks and other guarantors will form to protect all the deposit liabilities of an individual bank, not just the first $100,000 of a depositor's bank balance.

Exhibit 1

Flow of a Bank's Insolvency Loss If It Fails


Today with
Federal Deposit Insurance
FAILED BANK
Flow of insolvency loss
FDIC
(BIF, SAIF)
U.S. Treasury
Future with
100% Cross-Guarantees
FAILED BANK
Share of Insolvency Loss
Share of Insolvency Loss
Bank 1
Bank 2
Bank 3
Bank 4
Bank 5
First-tier guarantors
Losses, if any, that flow to guarantors of first-tier guarantors
Solvency safety net formed by the earning power and equity capital of the banking system. This safety net absorbs all bank insolvency losses not borne by first-tier guarantors.
FDIC
Backup Fund
Flow of loss in the highly unlikely event of a failure of the solvency safety net
U.S. Treasury

Note: Dotted line around the FDIC fund denotes the fact that this fund does not actually exist because it is incorporated in the consolidated federal budget. Losses paid by the FDIC actually count as government spending when money is disbursed.

One hundred percent cross-guarantees will use the enormous earning power and equity capital of the entire banking system, if necessary, to protect bank liabilities.

I might add we are looking at a banking system, even on a mark-to-market basis, that probably has in excess of $200 billion of capital.

At the same time, guarantors of banks will charge risk-sensitive premiums to compensate for the cross-guarantee risk they have assumed and to curb unwarranted risk-taking by guaranteed banks.

Cross-guarantee syndicates will close failing banks as they approach insolvency. This prompt closure will greatly minimize deposit insurance losses in the few institutions that will fail under the cross-guaranteed concept.

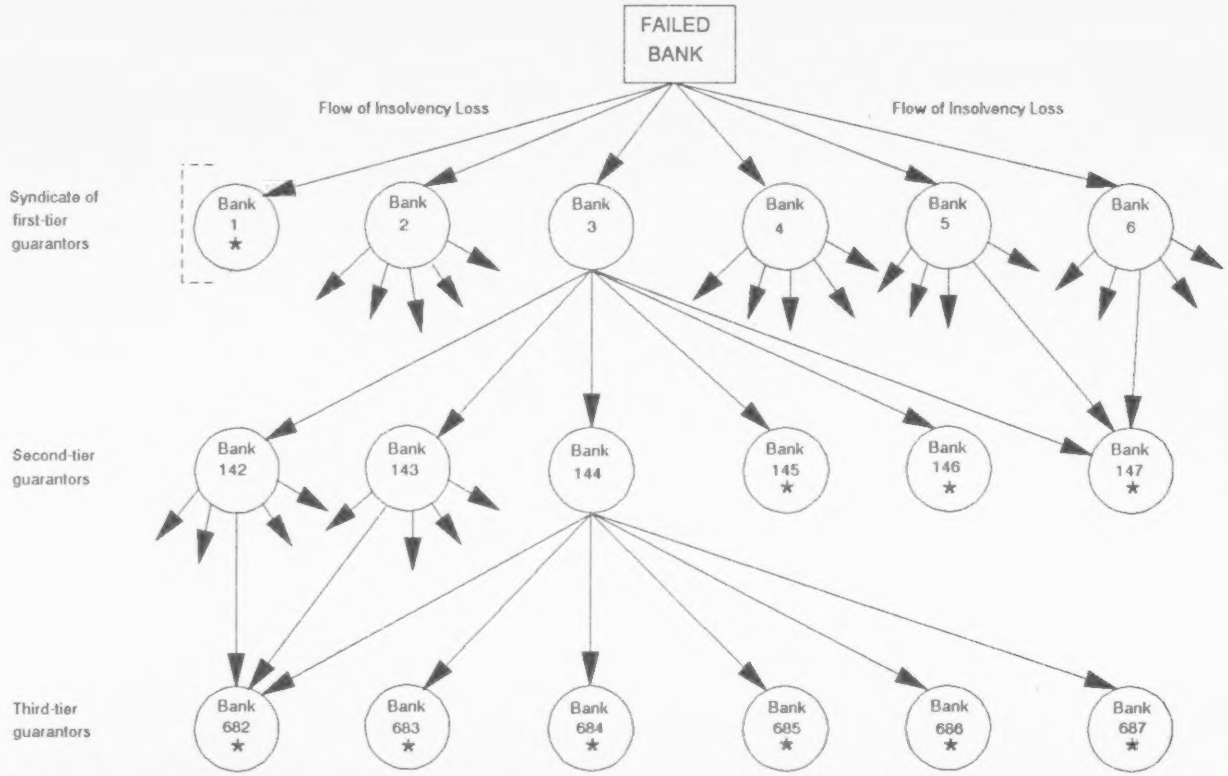
Besides shifting the depositor protection process to the private sector, the "solvency safety net" constructed by the "stop-loss" feature of 100 percent cross-guarantees will effectively privatize the Federal safety net. This action will reverse the dangerous and continuing expansion of the Federal safety net in recent years.

My second chart (exhibit 2) shows how the solvency safety net will work in practice. As you will note, the stop loss mechanism will spread large bank insolvency losses widely but thinly across the entire banking system.

The 100 percent cross-guarantee concept offers many benefits to the banking system, to the economy, to the American people, and to the political process. These benefits include completely integrating deposit insurance reform and structural reform by privatizing all banking and restructuring risks.

Exhibit 2

Example of How a Very Large Insolvency Loss Might Flow Through Multiple Tiers of Guarantor Banks under the Stop-Loss Reinsurance Provision of 100% Cross-Guarantee Contracts


FAILED BANK
Flow of Insolvency Loss
Flow of Insolvency Loss
Syndicate of first-tier guarantors
Bank 1 *
Bank 2
Bank 3
Bank 4
Bank 5
Bank 6
Second-tier guarantors
Bank 142
Bank 143
Bank 144
Bank 145 *
Bank 146 *
Bank 147 *
Third-tier guarantors
Bank 682 *
Bank 683 *
Bank 684 *
Bank 685 *
Bank 686 *
Bank 687 *

* Four first- and second-tier guarantors (Banks 1, 145, 146, and 147) andall the third-tier guarantors have no losses flowing out of them because their share of the failed bank's insolvency loss does not reach their stop-loss reinsurance limit.

Also, the 100 percent cross-guarantee concept could be implemented quickly. Banks and thrifts could begin opting into 100 percent cross-guarantees as soon as one year after enabling legislation was passed.

If Congress enacted this concept next year, for example, cross-guarantee contracts could become operational by the end of 1992 or early 1993.

This timetable would enable the American financial system to keep pace with the enormous financial restructuring taking place elsewhere in the world. At the same time, 100 percent cross-guarantees will be very beneficial to our nation's community banks and to the towns and cities they serve.

The 100 percent cross-guarantee concept also is the only comprehensive deposit insurance reform proposal that has been presented. All other proposals are fragmentary, at best.

Finally, the concept does not take anything away from existing protections for depositors; instead, it will add many protections while greatly strengthening the banking system and enhancing its efficiency.

It would be possible, for example, to recast the bank insurance fund as a backup fund to protect depositors up to $100,000 in case cross-guarantees ever failed to perform, which is highly unlikely.

Mr. Chairman, the time is drawing near when deposit insurance must be reformed in a very fundamental fashion. The 100 percent cross-guarantee concept is the only way to achieve that reform.

Thank you for your time and your patience.

I welcome your questions.

[The complete prepared statement of Bert Ely follows:]

TESTIMONY BY BERT ELY

to the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

on the subject of

DEPOSIT INSURANCE REFORM

May 17, 1990

Submitted by:

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DEPOSIT INSURANCE REFORM
by Bert Ely

SUMMARY

Deposit insurance reform is badly needed today. The continued hemorrhaging of the Bank Insurance Fund (BIF) and the $100 billion plus taxpayer bailout of the FSLIC clearly indicate that federal deposit insurance is not working. This should not be a surprise, for federal deposit insurance is inherently and hopelessly flawed. Franklin Roosevelt, in his very first news conference as President, warned that federal deposit insurance would "... put a premium on unsound banking in the future." Further, electronic and financial technology are rapidly undermining the efficacy of all forms of financial services regulation. Thus, the regulatory process is less and less able to contain deposit insurance losses, except at an enormous loss of banking productivity and increased risk to the federal safety net.

The current problems in federal deposit insurance also are blocking a long overdue restructuring of an increasingly obsolete financial services industry. Restructuring must permit new powers for banks and S&Ls that are now feasible with today's technology. Congress is reluctant, though, to grant those powers as long as it thinks that those powers might further decrease the safety and soundness of federally insured depository institutions. Thus, there is a growing recognition that deposit insurance reform and structural reform must progress together.

Federal deposit insurance cannot be fixed for many reasons. The most basic problem, however, is common to all government insurance and guarantee programs: Sound insurance mechanisms are incompatible with democratic government. In order to be successful, insurers must be able discriminate among insureds on an objective basis; government, however, is premised on nondiscrimination and equal treatment for all. Therefore, insurance programs of any type can operate successfully only in the private sector and without government subsidy.

Three major specific flaws with federal deposit insurance are as follows: (1) Banks and S&Ls are charged flat-rate insurance premiums no matter how soundly or how unwisely they are managed. (2) The political process and regulator timidity generally cause delayed closure of insolvent institutions, which greatly increases the insolvency losses in these failures. (3) The federal deposit insurance funds have no real capital; therefore, many of their losses are borne by taxpayers.

Three popular proposals to fix federal deposit insurance will not work. (1) Reducing deposit insurance from the present $100,000 limit will have no disciplining effect whatsoever; it may only cause losses to a few small depositors. (2) Attempting to discipline large depositors through some sort of "coinsurance" program will have little disciplining effect. Coinsurance is premised on the idea that the "too-big-to-fail" policy should be abandoned. Attempting to get rid of too-big-to-fail will be destabilizing to the financial system, it will increase deposit insurance losses, and it will greatly harm the domestic and international competitiveness of American-domiciled banks because other industrialized nations will not abandon their too-big-to-fail policies.

Attempts to reform federal deposit insurance probably will fall back on that old standby: more regulation. However, even more restrictive regulation of banks and S&Ls will turn them into narrow banks limited to investing only in short-term, low-risk assets. Narrow banking will harm banking productivity by destroying the synergies increasingly possible, because of technology, between bank assets and liabilities. Narrow banking also would not eliminate financial risk in the economy; it would merely shift much of this risk to nonbank firms. This shift would greatly increase risk for the federal safety net, which is administered by the Federal Reserve System as the country's "lender of last resort."

There is only one way to reform deposit insurance and that is to replace federal deposit insurance with 100% cross-guarantees. The 100% cross-guarantee concept is a self-insurance mechanism for the banking system. Cross-guarantees will use the earning power and equity capital of the banking system to protect all deposit liabilities, not just the first $100,000 of a depositor's bank balance. Cross-guarantees will use risk-sensitive premiums to curb unwarranted risk-taking by individual banks. Syndicates of banks, acting as guarantors of other banks, will close banks as they approach insolvency. Prompt closure of failing banks will greatly minimize deposit insurance losses in the few institutions that fail under the 100% cross-guarantee concept.

Besides shifting the depositor protection process to the private sector, the "solvency safety net" constructed by the "stop-loss" feature of 100% cross-guarantees will effectively privatize the federal safety net. This action will reverse the continuing and dangerous expansion of the federal safety net.

The 100% cross-guarantee concept offers many benefits to the banking system, to the economy, to the American people, and to the political process. Among the key benefits of 100% cross-guarantees are the following:

(1) Cross-guarantees will completely integrate deposit insurance reform and structural reform by permitting the privatization of all banking and restructuring risks.

(2) The 100% cross-guarantee concept could be implemented quickly. Banks and S&Ls could begin "opting into" cross-guarantees as soon as one year after enabling legislation was passed.

(3) The 100% cross-guarantee concept is the only comprehensive deposit insurance reform proposal that has been placed on the table. All other proposals are fragmentary at best.

(4) The concept does not take away any existing protections; it only adds protections while greatly strengthening the banking system. The BIF could be recast as the FDIC Backup Fund to protect depositors in case 100% cross-guarantees ever failed to perform, which is highly unlikely.

The time is drawing near when deposit insurance must be reformed in a very fundamental fashion. The 100% cross-guarantee concept is the only way to achieve that reform.

DEPOSIT INSURANCE REFORM

Mr. Chairman and members of the committee, I want to thank you for asking me to testify today on the subject of deposit insurance reform. I commend the committee for initiating a set of hearings on deposit insurance reform as it is rapidly escalating into one of the most important issues this committee will address in this decade.

Deposit insurance reform is needed today

America needs to reform deposit insurance as quickly as possible. Despite the best intentions of FIRREA (the Financial Institutions Reform, Recovery and Enforcement Act of 1989), another FSLIC fiasco could occur because electronic technology, and its offspring, financial technology, are rapidly destroying the efficacy of financial services regulation.

The FDIC will report shortly that the BIF lost money in 1989, its second year of losses. For each of the last six years (1984-1989), bank insolvency losses exceeded the premium income of the deposit insurer for banks (formerly the Federal Deposit Insurance Corporation (FDIC) fund and now the BIF.) The growing banking problems in New England and elsewhere strongly suggest that BIF's losses will continue for some years to come as the creditworthiness of American banks continues a decade-long decline.[1]

Federal deposit insurance has traditionally depended on regulation (the cop-on-the-beat if you will) to hold bank insolvency losses to an acceptable level. However, technology is rapidly destroying the three elements of any efficacious regulatory mechanism. These elements are: a slow rate of change that can accommodate the consensus building nature of the political process, ease in identify who to regulate, and homogeneity among regulatees so that all regulatees can comfortably operate under one set of regulations. Today, we live in a financial services world where rapid technological change is destroying the economics and the market structure of long-established financial service providers; where non-regulated firms compete directly against regulated firms, usually without the regulatory burdens of the regulated firm; and where regulated firms are becoming increasingly heterogeneous as each firm pursues a unique business strategy. No longer do all banks or all S&Ls do business the same way, as was the case just a few decades ago.

Deposit insurance reform is important not only because it is not working well, but also because it is blocking a long overdue restructuring of an increasingly obsolete financial services industry. More and more people are recognizing that the modernization of financial services cannot be accomplished without substantially restructuring various segments of the financial services industry. In some cases, technology increasingly permits the integration of financial products and delivery mechanisms that cut across traditional industry lines. In other cases, technology has unbundled financial products in a manner that permits elements of the unbundled product to evolve into separate industries.

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[1] James R. Kraus, "American Banks Seen Losing Edge" American Banker (April 27, 1990): 2.

Housing finance is an excellent example of the unbundling phenomenon. S&Ls used to be integrated housing finance producers. They made the home mortgage, they funded the mortgage, and they serviced the mortgage. Technology, however, has transformed housing finance into three distinct industries: mortgage origination, mortgage funding, and mortgage servicing. Each has different economies of scale and scope and each has a different although overlapping set of participants. In all three industries, many S&Ls are choking on the dust kicked up by the often unregulated leaders in each industry, leaders who usually are best positioned to operate efficiently in the industry of their choice. Little wonder, then, that the S&L industry as such is fast fading into oblivion.

The restructuring debate of necessity entails proposals about broadening the powers of federally insured banks and S&Ls to reflect the new technology so that these institutions can compete on a level playing field with unregulated and uninsured competitors. But this very appropriate question quickly arises: How can broader powers be granted to insured institutions without risking greater losses in the deposit insurance funds? There are no easy answers to this question, which is one reason why the powers debate has raged for almost a decade without resolution. However, it is increasingly recognized that deposit insurance reform and structural reform are highly intertwined. Some might say hopeless intertwined. It also is increasingly evident that these twin reforms must move ahead quickly if America's financial services providers are to have any hope of remaining competitive, both domestically and internationally.

Federal deposit insurance is not working because it is hopelessly flawed

Federal deposit insurance clearly is not working because it is hopelessly flawed and thus beyond repair. None other than Franklin Roosevelt recognized the shortcomings of federal deposit insurance when on March 8, 1933, at his first presidential news conference, he issued this prophetic warning:

> "... as to guaranteeing bank deposits ... the general underlying thought behind the use of the word 'guarantee' with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the Government starts to do that the Government runs into a probable loss.... We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future."[2]

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[2] "The Public Papers and Addresses of Franklin D. Roosevelt" (New York: Random House, 1938) p. 37.

Federal deposit insurance has failed because no government insurance scheme can ever function as a sound insurance mechanism. In fact, insurance of any type is a highly inappropriate government function because the tenets of insurance conflict with the tenets of democratic governance. Sound insurance programs can survive only if they discriminate. Their discrimination must be based on objective economic measures; nonetheless, they must discriminate. Democratic government is the opposite: All persons are equal before the law, and the law, and its accompanying regulations, must apply equally to all. Attempts by government to discriminate are quickly opposed by those who believe they will suffer unfairly if discriminated against. This is not to say that government does cannot discriminate on sound grounds, but it is much harder for a monopolistic government to discriminate fairly than it is for insurers in a competitive marketplace to discriminate fairly.

There are three specific flaws in federal deposit insurance which make it hopelessly unsound.

The flat-rate deposit insurance premium is the first flaw of federal deposit insurance. All banks pay the same deposit insurance premium rate no matter how prudently or how recklessly they operate. In effect, the drunk drivers of the banking world pay no more for their deposit insurance than do their sober siblings. The political process simply will not permit a government agency to charge the riskiest bankers what they should pay because these bankers will squawk the loudest and seek political intervention to be protected from paying what they should. My fellow witness today, Professor Kenneth Scott of Stanford University, expressed so well in an article he wrote almost twenty years ago why government agencies will never be able to properly establish risk-sensitive insurance premiums.[3]

Delayed closure of insolvent financial institutions is the second flaw in federal deposit insurance. Closing banks and S&Ls as they approach insolvency or just after they become insolvent should make deposit insurance a nearly costless proposition for a deposit insurer. In one sense, then, the enormous cost of cleaning up the FSLIC mess was caused almost solely by incredible delay in closing insolvent S&Ls. But almost without exception, governments delay in recognizing problems because the short-term political benefits of ignoring problems outweigh the usually higher cost of delay.

The rapidly escalating cost during the 1980s of bailing out the FSLIC became an acceptable rationale for not closing insolvent S&Ls because to do so would have boosted the federal budget deficit. This rationale conveniently suited executives of failing S&Ls who increasingly sought salvation in the political process because they had failed in the financial marketplace. On many occasions, the closure of these S&Ls was postponed, which inevitably raised the cost of failure when closure finally occurred.

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[3] Kenneth Scott and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," Stanford Law Review 23 (May 1971): 890-95 particularly.

A lack of real capital is the third major flaw of federal deposit insurance. Any reserves that a federal insurance fund claims to have simply do not exist. When an insured bank or S&L fails, its insolvency losses come straight out of taxpayers' pockets because the federal deposit insurance funds have no real capital. The insurance premiums collected by the FDIC in years past, when losses were low, were used at that time to pay other bills of the federal government; they were not accumulated as genuine capital. Therefore, when bank insolvency losses exceed premiums, as they have at the FDIC since 1984, these losses have been paid with higher federal borrowings.

Recent proposals to fix federal deposit insurance will not work

Numerous proposals have been offered in recent years to fix federal deposit insurance. All are attempts to fix the unfixable. None will work. These proposals fall into several major categories.

Reduce deposit insurance from the $100,000 level is one major reform proposal. Many suggest rolling back the deposit insurance limit to its 1980 level of $40,000, or to another level below $100,000. On an inflation-adjusted basis (as measured by the GNP deflator), the $40,000 limit in effect in March 1980, when the limit was last raised, is about $62,000 today.

Lowering the deposit insurance limit today to the range of $40,000 to $60,000 will have no impact whatsoever on the future performance of the deposit insurance funds.

My very rough estimate is that about 6% of all domestic bank and S&L deposits are in the $50,000 to $100,000 band. That percentage equals about $200 billion of the $3.4 trillion on deposit in the domestic offices of BIF- and SAIF-insured banks and S&Ls at the end of 1989. That is, lowering the deposit insurance limit from $100,000 to $50,000 will shift about $200 billion of deposits from the status of being explicitly insured to being explicitly uninsured. Lowering the deposit insurance limit would have differing affects on three types of depositors.

A substantial portion of the deposits in the $50,000 to $100,000 band are in accounts of $5 million, $10 million, or more. These deposits are placed in banks, usually larger ones, based on the depositor's belief in the too-big-to-fail policy and sometimes the depositor's evaluation of the bank's soundness. Because these depositors largely disregard the deposit insurance limit in determining where to place their funds, this first group of depositors will be unaffected by any lowering of the deposit insurance limit.

A second group of depositors really do worry about the $100,000 limit. Often these are individuals who have a substantial amount of their wealth, modest though it may be, on deposit in a bank or S&L. Many of these folks are retirees who have sold their home and are now living on the interest income from the certificate of deposit they have in a local bank or S&L. Lowering the deposit insurance limit will merely be an inconvenience for these folks, if they understand that they have to spread their savings over a larger number of institutions. For example, if the deposit insurance limit was lowered to $50,000, the retired auto worker and his wife from Flint, Michigan, who are now living in a trailer home in Winter Haven, Florida, would have to spread their life savings of $180,000 over four banks and S&Ls instead of just two, as is now the case, in order to continue to have fully insured deposits. Heaven help the infirmed widow in Beaver, Utah, though, who does not understands what lowering the insurance limit to $50,000 means, or who cannot easily open an account at a second bank. She will simply be out of luck when she loses some portion of the $80,000 from her husband's life insurance policy that she deposited in a small bank that is subsequently liquidated when it becomes insolvent.

A third type of affected depositor has account balances that fluctuate widely. These depositors include small businesses, professional people, and non-profit organizations. For example, these depositors might accumulate cash during the month to pays bills on one particular day or they may have a large inflow of cash receipts over a few days that must carry them through the rest of the month. These depositors, which number in the hundreds of thousands, if not more, will be affected by dropping the deposit insurance limit, since at times their account balances go over $40,000 or $50,000. These depositors may not even realize they have exceeded the insurance limit, for two reasons: one, they may maintain multiple accounts in one bank and two, they look only at their checkbook balance. Their checkbook balance will exclude check float (uncleared checks), which can be considerable at times if bill payments are bunched, yet check float is part of a depositor's balance for deposit insurance purposes.

Thus, at times during the year, the bank balances of hundreds of thousands of bank depositors in the United States exceed the $100,000 limit; the number exceeding a lower insurance limit will of course be even higher. If this type of depositor worries about the deposit insurance limit, their likely response will be to shift their balance to a larger bank, one with at least a billion dollars of assets, that they know is too big to fail.

Given the above analysis, the Congress should not spill political blood to pursue the hollow act of lowering the deposit insurance ceiling. Doing so will unnecessarily raise the ire of hundreds of thousands of people that represent a broad cross-section of America without having any substantive effect. Whatever the wisdom of raising the deposit insurance limit ten years ago, it will be politically unwise, and futile to boot, to now lower the deposit insurance limit.

Disciplining large depositors by getting rid of the too-big-to-fail policy is a second reform proposal. Too-big-to-fail is a misnomer. The criticized policy really is too-big-to-liquidate. Continental Illinois failed even though it was not liquidated -- its top management lost their jobs, its directors were disgraced, and its stockholders effectively were wiped out. The same holds true for

FirstRepublic, MBank, and other large, failed banks. Despite these clear failures, many believe that these banks should have been liquidated so as to impose losses on their large depositors.

There are three reasons why attempting to impose losses on large depositors, (i.e., those with balances over $100,000) is unwise public policy.

First, an announced policy of liquidating a large bank or, alternatively, transferring only insured deposits into a "bridge bank," if taken seriously by the financial world, will set off a race for the door every time rumors circulate that a bank with substantial uninsured deposits is in trouble. This will be the case because those depositors who make it out the door before the bank is closed will be fully protected while those who don't will suffer a loss. The race will be won by those who are fastest rather than those who are the most deliberate. The watchword will be: When in doubt, run. Such sprints will be destabalizing to the financial system while destroying intangible yet worthwhile going concern value in the affected banks. This destruction of going concern value is economically wasteful; it is about as sensible as the Eighteenth Century medical practice of bloodletting that kill George Washington and thousands of others.

Second, liquidating failed banks is more expensive for the deposit insurer than merging the failed bank into another institution. Mergers do not impose losses on depositors and other creditors. Liquidations are more expensive than a merger subsidized by a deposit insurer because liquidation destroys going concern value which otherwise can be captured to the benefit of the deposit insurer if the failed bank can be sold or merged as a going concern. Liquidation drives away long-time depositors and it upsets relationships where the bank customer is both a depositor and a borrower. In effect, liquidation destroys a market presence built over many years. This destruction of going concern value is why in the world of commerce, actual liquidations are a last resort for disposing of a bankrupt business. I have roughly estimated that the rapid shrinkage of Continental Illinois in 1984 added at least $100 million to the FDIC's loss in that situation. Had Continental Illinois been liquidated that year, as some have suggested, the FDIC's additional losses would have been hundreds of millions of dollars. Liquidation is bad economic policy; therefore, liquidation is bad public policy.

As a practical matter, though, America will not abandon the too-big-to-fail policy because other industrialized nations are unwilling to impose bank insolvency losses on depositors. This is the third reason why the too-big-to-fail policy is here to stay.

As Gerald Corrigan, president of the Federal Reserve Bank of New York, testified to this committee two weeks ago, banking regulators in other countries have been extremely reluctant to impose losses on depositors and creditors in larger banks since the failure of the Herstatt bank in Germany in 1974. These regulators apparently are too scared, and wisely so, of financial instability that can occur when attempting to impose losses on depositors. These regulators apparently believe that it is far more preferable for the national government and the surviving banks to absorb the insolvency losses of a failed bank rather than attempt to impose those losses on depositors and other creditors.

If America abandoned its too-big-to-fail policy, and other nations did not, many larger American banks would clearly be at a competitive disadvantage both domestically and internationally since large depositors would have less reason to fear keeping deposits in a foreign bank than they would in a domestic bank. Regulators understand this competitive issue, which is why they resist ending the too-big-to-fail policy. Thus, I do not think America will abandon too-big-to-fail unless Congress mandates an end to this policy and can enforce this policy against the regulators' strong desire to do otherwise.

Early closure of failing banks and S&Ls is a third reform proposal. Promptly dealing with a failing bank or S&L through a sale or merger is a laudatory policy objective. If an institution can be closed and sold before it actually becomes insolvent, its failure should not cost its deposit insurer any money. However, it will be next to impossible for Congress to legislate a rule that will consistently force the closure of institutions approaching insolvency because banking regulators will vigorously oppose any attempts to limit their freedom of action in dealing with a failing bank or S&L. Banking regulators everywhere do not like to be bound by rules or hard-and-fast policies that will prevent them from exercising the discretion they love so much when dealing with a failing institution.

Bank and S&Ls also will oppose any legislative policy that dictates closure before insolvency. The owners and managers of these institutions will want every opportunity to attempt to avert failure should their institution ever get into trouble. Their opposition to early closure will quickly be felt in the political process. Past acts of forbearance for weak institutions, such as farm and energy banks have received in the 1980s, are ample evidence that Congress will grant forbearances in the future for what will seem at the time to be very legitimate reasons. Thus, with two strong sources of opposition to prompt closure, I do not think prompt closure can ever be depended upon to work for a federal deposit insurance program.

The deposit insurance danger facing America today

America faces this danger today: Increased regulation of banking that attempts to limit federal deposit insurance losses through increasingly severe regulation will strangle the banking industry. Narrow banking, the effect of highly restrictive banking policies, will be detrimental to the productivity of the American economy. Narrow banks would effectively be limited to holding short-term, low-risk assets funded by only by deposits. As we increasingly observe around the world, strong, vibrant economies demand equally strong and productive banking systems. Productive banking entails risk-taking beyond the scope that would be permitted for narrow banks.

Sterile narrow banks are the best we can hope for if we continue to tighten banking regulation. A far worse outcome will be severe regulation that perversely weakens banks so that high deposit insurance losses continue unabated.

An unintended consequence of narrow banking would be to shift substantial risk from the banking system to other types of financial institutions that currently are not explicitly covered by the federal safety net (which in realty is the American taxpayer). In effect, as risk is forced outside the banking system, Congress or the Federal Reserve System, acting on its own in an emergency situation, might have to broaden the federal safety net to compensate for reducing the risk of loss under federal deposit insurance. In a process comparable to squeezing a balloon, new problems in the financial system will surface as old ones are regulated out of existence.

The dichotomy between deposit insurance and the federal safety net, as that net is administered by the Federal Reserve System, can best be viewed from this perspective. Deposit insurance represents the newer pipeline into the U. S. Treasury through which taxpayer monies now flow to cover bank and S&L insolvency losses. The Federal Reserve represents the older pipeline into the Treasury through which taxpayer monies will flow if the federal safety net suffers a loss. A shift towards narrow banking, which is not genuine deposit insurance reform, represents an attempt to shut down the deposit insurance pipeline. However, because narrow banking, instead of eliminating financial risk, mere shifts that risk to other types of financial service providers. In effect, narrow banking would increase the probability that the federal safety net, managed by the Federal Reserve, will suffer losses of taxpayer funds.

Interestingly, Federal Reserve Chairman Alan Greenspan and New York Fed President Gerald Corrigan have hinted in recent speeches that the federal safety net may have to be expanded. As Congress considers deposit insurance reform, it must ask itself this question: Should the expansion of the federal safety net be a price that has to be paid in order to reduce the riskiness of federal deposit insurance? I think not, for deposit insurance can be reformed while almost completely eliminating risk to the federal safety net. The 100% cross-guarantee concept is that reform.

Viewed from another perspective, the failings of federal deposit insurance are costly; therefore, we need to reform deposit insurance. But federal deposit insurance is irreparable; therefore, the risk and rewards of insuring deposits must be shifted to a private sector mechanism that can genuinely overcome the inherent and uncorrectable shortcomings of federal deposit insurance. The 100% cross-guarantee concept is that mechanism.

The 100% Cross-Guarantee Concept

Briefly, the 100% cross-guarantee concept is an industry self-insurance mechanism that will use the earnings and capital resources of the banking system to protect all deposits in every bank.[4] Each bank will enter a cross-guarantee contract that will protect all deposits, including balances of more than $100,000, from any loss of principal, interest, or liquidity if it fails (i.e., becomes insolvent). Other liabilities of the guaranteed institution also could be protected under the 100% cross-guarantee contract. Each cross-guarantee contract will be issued by an ad hoc syndicate of banks called "first-tier guarantors." Each guarantor bank itself will be guaranteed by a separate syndicate of guarantor banks. Syndicates will be organized by specialized firms called syndicate agents. Cross-guarantee contracts will be syndicated in a manner comparable to the syndication of insurance risks at Lloyd's of London.

Guarantor banks will regularly collect a risk-sensitive deposit insurance premium from each of the banks they guarantee. Although risk-sensitive premiums will discourage unsound banking practices, a few guaranteed banks still will slide hopelessly towards insolvency. Thus, each cross-guarantee contract will permit the syndicate of guarantor banks to take over the guaranteed bank before it becomes insolvent. The syndicate will then be able to fully protect all deposits and other guaranteed liabilities without any loss.

If the guarantors do not take over the failing bank quickly enough, they will have to write checks to protect depositors and other guaranteed liabilities against any loss. In the rare event of a large loss or a concentration of losses, a "stop-loss" provision in each contract will permit a portion of that loss to be passed through the guarantor banks to their own guarantors. If necessary, the stop-loss provision will spread the loss across the entire banking system. In effect, the earning power and the equity capital of the banking system tapped by the stop-loss feature will construct a "solvency safety net" that will permit the banking system to survive losses even more extensive than those suffered by depositors during the Great Depression. Unlike the federal safety net, the solvency safety net will not consume taxpayer dollars to protect depositors. Deposits up to $100,000 can be protected further by retaining the BIF as a backup to 100% cross-guarantees.

The attached exhibits 1 and 2 illustrate the 100% cross-guarantee concept. Exhibit 1 contrasts 100% cross-guarantees with the flow of bank insolvency losses under federal deposit insurance. Exhibit 2 shows the flow of a very large bank insolvency loss through several layers of guarantors under the stop-loss provisions of a cross-guarantee contract.

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[4] Unless otherwise stated, the terms "banking" and "bank" encompass commercial banks, savings banks, and S&Ls unless otherwise stated. These terms do not encompass credit unions and money market mutual funds.

The 100% cross-guarantees will protect depositors and taxpayers better than federal deposit insurance because the cross-guarantee concept will be much more responsive to marketplace forces that will seek to minimize bank insolvency losses. Guarantors will set a range of premiums that may charge the riskiest bankers 20 times as much as the most prudent bankers. Intoxicated bankers truly will pay for the carnage they can cause while prudent bankers may pay as little as 4 basis points (.04%) annually, about one-fourth of the premium rate they are scheduled to pay next year. Where high premiums do not curb risky banking, "equity market intervention" usually will occur: Stockholders will use proxy contests to force management changes, or new investors will take over and recapitalize failing banks. These investors will profit when cross-guarantee premium rates drop as capital is pumped into the bank.

Exhibit 3 illustrates the likely interaction between cross-guarantee premium rates and capital levels. The management of the top bank (Bank 1) responded to a rising premium rate by reversing the course of the bank and slowly restoring its capital level. The middle bank (Bank 2) was recapitalized, which quickly brought down its premium rate as the bank moved toward renewed financial strength.

The bottom bank (Bank 3) kept on sliding towards insolvency until its guarantors took it over before it became insolvent. This timely takeover kept the guarantors' losses at zero. It is crucial to the 100% cross-guarantee concept that the takeover point specified in a cross-guarantee contract be determined solely by negotiation between the guaranteed bank and its syndicate of guarantors.

Prompt closure of failing banks (ideally before they become insolvent) by their guarantors, coupled with the solvency safety net created through the stop-loss mechanism, will easily contain bank insolvency losses within the private sector. The 100% cross-guarantee concept is strengthened further by a minimum equity capital requirement for the banking system (but not for individual banks) and by risk diversification requirements imposed on both guarantors and on individual cross-guarantee contracts. These safety features are among the seven safeguards built into the 100% cross-guarantee concept.

The Many Benefits of 100% Cross-Guarantees

The 100% cross-guarantee concept offers more than a score of benefits to the banking system, to the economy, to the American taxpayer, and to the political process. These benefits can only be summarized here. The order in which they are presented does not diminish the importance of those benefits not listed first.

Benefit 1. The 100% cross-guarantees are the only way to completely integrate deposit insurance reform and the restructuring of financial services because 100% cross-guarantees will completely shift restructuring decisions and associated insolvency risks to the private sector.

Benefit 2. Implementation of 100% cross-guarantees can occur much more quickly and completely than any other deposit insurance reform proposal. Many banks and thrifts will be ready to switch to 100% cross-guarantees as early as the first anniversary of the legislation authorizing 100% cross-guarantees.

Benefit 3. The 100% cross-guarantee concept represents the only comprehensive reform of deposit insurance that has been offered. Further, 100% cross-guarantees will reform federal deposit insurance by effectively replacing it. All other proposals, by attempting to reform federal deposit insurance, are trying to repair the irreparable.

Benefit 4. The solvency safety net constructed by the stop-loss feature in all cross-guarantee contracts will effectively replace the federal safety net, thus eliminating the risk of loss to taxpayers associated with the federal safety net. Shifting the safety net function to 100% cross-guarantees will then permit the Federal Reserve to concentrate on its monetary management duties.

Benefit 5. The 100% cross-guarantees will not take away any existing protections for depositors and the financial system; cross-guarantees will only add to the now existing protections. Retaining federal deposit insurance, up to just $100,000, only as a backstop for 100% cross-guarantees would give small depositors confidence that their deposits are just as well protected as they now are. Because of the strength of 100% cross-guarantees, it is highly unlikely that this backup protection would ever be called upon.

Benefit 6. The 100% cross-guarantees will dramatically reverse the declining creditworthiness of American banks. This reversal in turn will raise public and marketplace confidence in American banks, thus allowing them to raise funds more cheaply. Cheaper funds will bring lower interest rates to borrowers.

Benefit 7. The 100% cross-guarantees will enhance the overall competitiveness of American banks. Not only will they enjoy a lower cost of funds, but appropriately capitalized banks will pay substantially less for deposit insurance than they now pay. In addition, banks will be free of many regulatory burdens that now add greatly to their operating expenses while limiting their operational flexibility.

Benefit 8. The 100% cross-guarantee concept builds on the existing strengths of the banking system, most notably the equity capital already invested in it. This capital and its earning power are more than enough to enable the banking system to withstand another Great Depression, once 100% cross-guarantees become a reality.

Benefit 9. The 100% cross-guarantee concept will greatly increase financial stability within the banking system by explicitly protecting all domestic and foreign deposits in American banks from bank insolvency losses that occur for whatever reason. This explicit protection will end uncertainty about the strength of the banking system whenever a bank with substantial uninsured deposits (deposits of more than $100,000 per depositor) gets into financial difficulty. Today, this uncertainty is competitively damaging to American banks because banks in other industrialized nations are not afflicted by uncertainties about the strength of their financial institutions.

Benefit 10. By protecting all deposits, 100% cross-guarantees will eliminate the daylight overdraft risk. A daylight overdraft is the risk that a bank will not be able to cover its payments system overdraft at the end of a business day because it has suddenly become insolvent. Because 100% cross-guarantees could easily be extended to cover all liabilities of the payments system, guarantors will effectively bear daylight overdraft risk as part of assuming the overall solvency risk of a guaranteed bank.

Benefit 11. Timely takeovers of failing banks, before they become insolvent, will improve the overall efficiency of the economy by ridding the banking system of inefficient competitors. One of the hidden costs of the FSLIC debacle has been that it has burdened the banking system with overcapacity in the form of inefficient and insolvent S&Ls whose losses have been subsidized by the taxpayer.

Benefit 12. The 100% cross-guarantees will eliminate any need for depositor discipline. Because guarantors will protect all deposit balances, including balances of more than $100,000, there will be no need to rely on depositors to discipline the risk-taking proclivities of bankers. Thus, 100% cross-guarantees will shift risk assessment activities from a highly risk-adverse set of creditors (bank depositors) to that source of funds (equity capital) that is best suited to assess and price financial risks.

Benefit 13. The 100% cross-guarantee concept completely eliminates the regulatory practice of too-big-to-fail. Today, regulators cower at the thought of liquidating a large bank for fear that uninsured depositors in that bank, and in other banks, will stampede. However, because guarantors will protect all deposits, large depositors will not panic even if the biggest bank is taken over by its guarantors and sold to another bank or even liquidated. A weak bank may lose depositors who are dissatisfied with the bank's services, but depositors protected by 100% cross-guarantees will not flee out of fear for their funds.

Benefit 14. Because 100% cross-guarantees will eliminate practically all risk to taxpayers, federal deposit insurance will no longer represent a $2.8 trillion contingent liability of the federal government.

Benefit 15. The risk-deterring effect of risk-sensitive premiums will encourage banks to lend and invest more wisely than many banks now do. Wiser lending will lead to a more productive use of credit within the economy, which in turn will enhance GNP growth. In effect, risk-sensitive premiums will eliminate the "moral hazard" in deposit insurance that has caused so much wasteful lending and investing in recent years.

Benefit 16. Risk-sensitive premiums will largely, if not completely, eliminate the cross-subsidy in flat-rate deposit insurance premiums, a subsidy that flows from good banks to the bad. In 1991, that cross-subsidy will cost America's better banks $3-$4 billion. Risk-sensitive premiums will cause the nation's riskier banks, taken as a group, to pay for most, if not all, of the insolvency losses the failed banks in this group incur.

Benefit 17. The 100% cross-guarantees will permit banks to escape the one-size-must-fit-all mentality of bank regulation. Regulation effectively will shift to the cross-guarantee contract and to the risk-balancing incentives of risk-sensitive premiums. This shift will give individual banks the flexibility to negotiate contractual terms that will permit them to innovate at their own pace and to tailor their capital structure to the lending and investing strategy best suited for that bank.

Benefit 18. The 100% cross-guarantees will greatly improve opportunities for community banks by freeing them of the practical effect of the too-big-to-fail policy. No longer will community banks be constrained from accepting deposits of more than $100,000. Cross-guarantees also will have an especially beneficial effect on the cost of funds for community banks in addition to permitting them to operate more efficiently. Without 100% cross-guarantees, many community banks will have an increasingly difficult time surviving in the banking marketplace.

Benefit 19. The 100% cross-guarantee concept can easily be extended to protect the liabilities of all providers of financial services, including securities firms, money market mutual funds, insurance companies, and even government-sponsored enterprises (GSEs).

Benefit 20. The 100% cross-guarantee concept can be structured to permit nonbank firms to participate as guarantors, provided that the cross-guarantee obligations of these firms are themselves guaranteed by other guarantors. Broadening the capital base available to guarantee bank deposits and other bank liabilities in this manner will further strengthen the financial backing of America's banks.

Benefit 21. Perhaps the greatest benefit of 100% cross-guarantees will be to substantially depoliticize the banking business because banks will no longer have an incentive to seek political salvation for their banking troubles. Thus, 100% cross-guarantees will free the political process of the inherent flaws of federal deposit insurance.

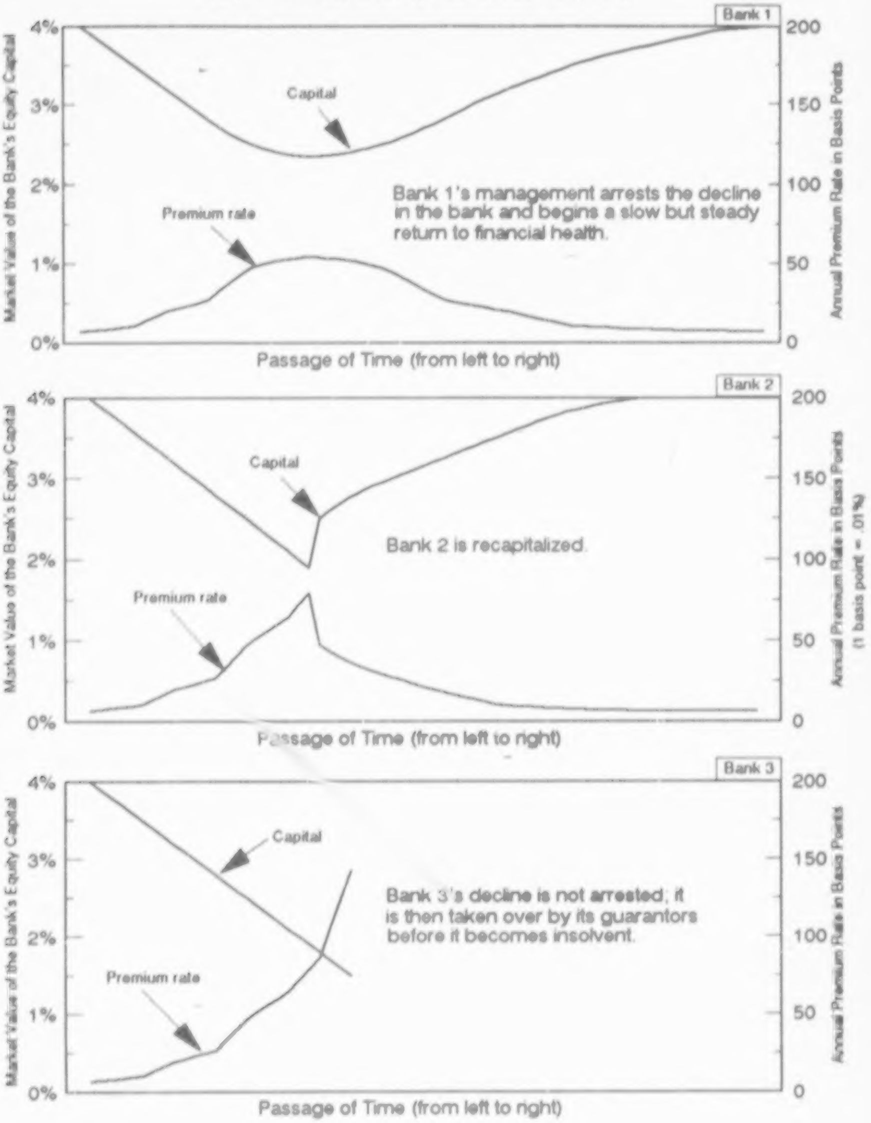
Conclusion

The 100% cross-guarantee concept offers the only comprehensive solution to the irreparable problems of federal deposit insurance, problems increasingly recognized for what they are. Cross-guarantees also will bring many benefits to the American economy and to the American people while preserving the promise of federal deposit insurance. The way is clear. Now is the time to act.

Exhibit 3

Interaction Between Premium Rates and Capital Levels for Three Banks

(All three banks are declining at the same rate until they pull out, are pulled out, or do not pull out of their decline.)



The **Chairman**. Very good. I appreciate your bringing us an idea and putting it forward with some enthusiasm. I am going to ask your opinion on some other issues, too, just a little bit later.

Let me acknowledge, if I may, the arrival of two of our colleagues, Senator Wirth and Senator Dixon. Before we go to Mr. Scott, I wonder if either of my colleagues have an opening observation or comment they want to make. We have heard from two of our witnesses thus far and we're about to hear from the third.

Senator Dixon, would you have any comment?

Senator **Dixon**. Well, I thank the Chair, and I would appreciate very much if the record could show my statement. And I'll not impose upon the Chair by reading it now.

The **Chairman**. Very good. We will make it a part of the record. Senator Wirth.

Senator **Wirth**. Same thing. I'm delighted to have you all here. I'm very pleased you are looking at this issue, Mr. Chairman.

Senator Gramm and I, 2½ years ago, had introduced legislation that included a major title on looking at the whole issue of deposit insurance, which we still—I certainly still believe we ought to be examining carefully. And I'm very pleased that we have begun that operation, painful as it may be. And I thank you for your good leadership.

Senator **Dixon**. If I may, Mr. Chairman, I would like to observe that I think the witnesses are probably aware of the fact that I've been looking very seriously at risk-based deposit insurance. We've been working assiduously on that and expect to, in time, have something before the committee along those lines.

The **Chairman**. Let me also acknowledge the presence of Senator D'Amato.

Senator D'Amato, did you have an opening comment to make?

Senator **D'Amato**. Mr. Chairman, in the interest of time, I'm going to ask that my statement be included in the record as if read in its entirety.

The **Chairman**. Very good. We will also insert statements from Senators Dixon, Sasser, Graham, Sanford, and Heinz.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the committee considers the question of deposit insurance reform. We have a good group of witnesses before us this morning, and I look forward to their testimony.

As some of those in attendance this morning know, I am working on a deposit insurance reform proposal that is centered around a risk-based insurance premium mechanism. I do not want to discuss the details of the approach I am considering this morning, however, because the proposal is still evolving. Instead, I would like to say a few words about the need for reform.

Given the collapse of the savings and loan insurance fund, it may seem odd to be discussing the question of why we need reform. The truth, however, is that the best case for deposit insurance reform is not quite as obvious as the thrift crisis might make it seem.

We must first remember that the banking system was very stable from the time deposit insurance was first enacted in 1933 until the late 1970's—a period of close to 50 years. During that time, there were only about 7 failures a year. Banking was as close to a sure thing as one could get in American business.

By the late 1970's, though, things started to change. The result of these changes was that the banking industry's protected, semi-monopoly franchise status was ended. Banks became subject to the marketplace. What that meant is that issues that didn't much matter before, issues like "the moral hazard implicit in deposit insurance" and "too big to fail" began to matter a great deal.

We cannot legislatively protect banks from either increasing international competition or from competition from other segments of the U.S. financial services industry. What we have to do, therefore, is reform our safety net, including our deposit insurance system, so that it fits the changed circumstances the industry and Federal regulators now face.

Deposit insurance has been an overwhelming success, and it cannot be abandoned. We also cannot afford to adopt the European model, which is based on less explicit deposit insurance protection, but which, in reality, is based on a Government-sanctioned "too big to fail" concentrated banking industry.

What we need to do is to put more discipline into the deposit insurance system, but do that in a manner that preserves the unique features of the U.S. banking industry—its local orientation, its pro-competitive, unconcentrated nature, and its innovative character.

Deposit insurance reform can accomplish this objective. It can eliminate the "moral hazard" and deal with "too big to fail." Coming up with a sound package of appropriate reforms will not be easy. It will be very controversial, but it must be done.

STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Mr. Chairman, today we will be looking at a difficult and complex issue—one for which there are no easy answers. Federal deposit insurance has been the cornerstone of our financial system and has provided individuals a sense of security about their money for over 50 years. Yet, as the thrift crisis has unfolded, it has become clear that deposit insurance is fraught with pitfalls and merits examination. The fact that you have called this series of hearings attests to your foresight and fortitude in facing up to the tough challenges in the financial system today.

In many respects, FIRREA, the Savings and Loan Act passed last year, marks a watershed—a place from which there is no turning back. We learned many lessons in the thrift crisis and in FIRREA. But if there's one thing that's now eminently clear, it's that the taxpayers stand behind the deposit insurance funds. As we move forward with future banking legislation, we should have as our goal strengthening the industry and reforming the system, so as to limit the taxpayers' exposure.

I don't think that lowering the ceiling on insured deposits is the answer. I fear that this would shatter depositor's confidence in the banking system and spur an exodus of funds into other types of financial instruments.

However, something must be done to address the issue of "moral hazard." All too often, it pays for federally insured institutions to gamble with depositor dollars by making risky investments. If the risk pays off, the owners win. If not, the Federal Government—the taxpayers, that is—are left on the hook.

The "too big to fail" issue must also be examined to ensure equity in deposit insurance premiums for small and large institutions. Depositors in big banks don't have to worry about the $100,000 limit. They know the Government won't close the bank—so they're covered no matter how much money they have.

Since large banks obtain a much higher share of their funds from foreign deposits, they pay lower effective premiums. Essentially, it means that the big bank's cost of funds is much less than that of medium-sized and smaller banks. It gives them an unwarranted competitive advantage. Often small and medium-sized banks pay the same amount of premiums as competitors two to three times their size.

As I mentioned at the beginning, none of the answers to these questions will be simple. The Treasury report on the deposit insurance system due out early next year should shed some light on both problems and solutions. In the meantime, I look forward to the thoughtful testimony of our witnesses and to working with you to formulate a plan for a strong deposit insurance system.

STATEMENT OF SENATOR BOB GRAHAM

Senator GRAHAM. Mr. Chairman, let me congratulate you for scheduling these next several hearings on deposit insurance reform. This issue may be one of the most important our committee considers. It goes to the heart of the problems we have encountered in the savings and loan industry and will dramatically impact the future debate on the structure of the U.S. financial industry.

The chairman and my committee colleagues may remember that I introduced a free-standing bill as well as offering an amendment to FIRREA to revise the deposit insurance system by permitting the Federal Deposit Insurance Corporation [FDIC] to establish risk-based permiums based on categories of institutions that present particular types of risks to the insurance fund. The risks would have had to be greater or lesser than those presented by the "typical" institution, and this provision gave the FDIC the ability to reflect that risk profile in the assessment rates. The ability to impose risk based premiums would not have arisen until after the fixed premium schedule set forth in the FIRREA expires. The bill further provided that if risk-based premiums were established, any rebates would be made in the same manner.

In the end, FIRREA only authorized a study to be done on risk based premiums instead of authorizing language. The study was mandated in both the FDIC section of the bill as well as the Treasury study. Both FDIC and Treasury studies are supposed to examine the establishment of premium assessment categories related to types of risk to the insurance funds and to report back to Congress by March 1991 with its recommendations. If the Corporation does recommend the establishment of a risk based approach then the Corporation should also set forth a timetable and plan for implementation.

My original bill was intended to buffer the insurance fund from insurance losses under normal economic conditions and perhaps decrease the cost of operating the deposit insurance system by pricing risk on a risk based system.

The FDIC proposed a risk based insurance provision be added to the original administration bill on the savings and loan crisis that they were going to send to the Hill. However, it was not included when their bill was released. Currently, the FDIC is requesting comments on risk based deposit insurance assessments from the public. I look forward to the outcome of their study and the committee's continuing review of the deposit insurance system.

STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman, and I would like to thank our distinguished panel of witnesses. Certainly there are few issues this committee will consider this session that are as important as deposit insurance reform. If the savings & loan crisis taught us nothing else, it taught us that we need to be more careful about what we require the Federal Government to stand behind. We must be more prudent about the risks the Government insures and we must be more aware of the relationship between Government insurance and the regulatory system governing all institutions which receive such insurance.

This morning, we hear from a very distinguished panel of experts on deposit insurance and its implications for the future of our financial system. We have all read about a wide variety of proposals, ranging from complete elimination of deposit insurance to scale-backs to $100,000 per person, to minor adjustments to the current system, to risk based premium programs. I think it is essential for this committee to examine these options and to try to understand as much as we can about what they would mean for all financial institutions, both large and small.

I believe that this committee simply must take action to modernize the laws governing our financial institutions and that such modernization efforts will undoubtedly be linked to reforms in deposit insurance. At the same time that we create a system to provide for the most competitive financial institutions in the world, we must ensure an adequate degree of market discipline and a limited amount of risk taking by the Government. We also must ensure that proper controls are in place to ensure that whatever deposit insurance system we come up with compliments our regulatory structure, and does not create incentives for excessive risk taking.

I look forward to the testimony of our witneses as we explore a variety of options to being needed change to our deposit insurance system.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming today's witnesses as this committee examines the Federal Deposit Insurance System. The issues is not whether to reform the system, but rather how to reform the system. The savings and loan crisis has provided billions of reasons why the deposit insurance system must be changed.

The current Federal Deposit Insurance System is an insurance system in name only. No other insurance system would charge the same premium to all policy holders irrespective of the risks. No other insurance system would place a limitation on coverage and then protect the insured and uninsured alike. No other insurance system would keep reserves at levels that bear no relationship to the actuarial risks of loss.

Today's Federal deposit insurance policy works more like a Federal credit card. Financial institutions are encouraged to go on a whirlwind shopping spree at the taxpayers' expense. As a result, the Resolution Trust Corporation is currently holding the largest garage sale in the history of the world.

Mr. Chairman, the deposit insurance system is not working when we must drain the savings of American taxpayers to protect the savings of insured depositors. I look forward these witnesses proposals to fix a system that is both literally and figuratively broke.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, dramatic changes in both the domestic and international financial environments have brought us to the point where we must consider major reform of the legal structure of the financial services industry.

Today's witnesses I am sure recognize the primacy of history over reason in the formation of our current bank regulatory system. Hearings such as this should help to promote a broader debate, one focused upon clear national priorities: stability, domestic competition and foreign competitiveness. The time has come for a new legal and regulatory structure that permits the free market rather than governmental inertia to determine whether any type of business is compatible with ownership of a depository institution.

There are two important issues that are crucial to any action. How do we limit the market distortion of deposit insurance? And how much of a firewall is necessary to protect insured deposits from the risks of the marketplace?

Through these hearings we must seek to focus the debate on the larger and increasingly pressing issues of international competitiveness, deposit insurance reform, consumer benefit and efficient use of financial resources.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Scott, as you can see, when the word got out that you were about to speak, all of a sudden, Senators started appearing in great numbers.

So we would like to hear from you now.

STATEMENT OF KENNETH E. SCOTT, PARSONS PROFESSOR OF LAW AND BUSINESS, STANFORD LAW SCHOOL, STANFORD, CA

Mr. SCOTT. Thank you, Mr. Chairman, members of the committee. I have a prepared statement which is based upon a longer research paper, both of which are submitted for the hearing record. In these remarks, I'd like to focus on simply a few points, and in doing so try to deal not with a specific reform proposal, but with a threshold issue. That is: How should any or all reform proposals be judged? What should the criteria for evaluating deposit insurance reform ideas be?

The criteria, it seems to me, have to derive from the fundamental flaws of present deposit insurance and the need, therefore, is to separate the central from the peripheral issues.

What are the basic defects that any genuine solution must fix? The basic defects, in my view, are that we have a deposit insurance system that takes whatever kind or degree of external shock it is confronted with and itself magnifies that shock and the losses and strains that are put upon the deposit insurance system.

So, the perspective that I want to emphasize is that incentives are at the core of the problem, as our recent savings and loan experience should make clear. But, the lesson is not limited to the savings and loan industry. The same incentive problems are at work in the bank deposit insurance system and they have this same tendency to spread.

What are the incentive distortions that I am talking about? There are really two categories. There are incentives at the level of the management of the insured institution, and there are incentives at the level of the management of the insuring agency. Let me take them in that order.

First of all, deposit insurance distorts decisionmaking by the management of the insured institution. The mechanism whereby this occurs may be familiar, but let me run through it briefly, at any rate.

The deposit insurance premium is a flat rate across all institutions, fixed by statute. That means that it ignores variations in the riskiness of the loans and investments of insured institutions, the degree of imbalance in maturities between their assets and their liabilities, differences in the amount of capital or in the capability of management. The high-risk institution pays the same premium rate as the low-risk institution.

What that does is create a constant bias throughout our financial system—both banks and S&L's—to take greater risks than they would otherwise for the greater potential returns.

Now, in the usual firm, the tendency to take greater risk for greater expected returns is held in check by creditors who charge more as their extensions of credit are subjected to more risk. And, therefore, they impose restrictions on management. They monitor the firm more closely. They impose risk premia as part of their charges and their interest rates.

These checks are much weaker for banks. The deposit creditors are insured. Why should they worry? And the insurance fund, by statute, cannot charge more.

So, most all of the higher anticipated returns from taking greater risk are captured by the bank's owners. In effect, deposit insurance subsidizes risk-taking and creates a constant bias in management's decisionmaking.

And the smaller the equity position of the bank, the greater the subsidy and, therefore, the more powerful the bias. As a bank's capital approaches zero, the distorted incentive becomes overwhelming. The owners have nothing left to lose and can take any gamble—plausible or not—with the taxpayers' money.

This is why the savings and loan losses, which were bad enough in the mid-1980's, simply exploded in the latter 1980's. Another $50 billion or so disappeared—and not to Swiss bank accounts or high living. That can't account for the sums we are talking about. It went into projects that made sense only because decisionmaking incentives were so badly distorted.

So, the first criterion, I would argue, for judging any deposit insurance reform proposal must be: How well does it remove the subsidy to risk-taking in the present system?

And be clear about it. Ending a subsidy will always be fought by those who are now receiving it. It is not going to be a painless undertaking.

At the second level, we have a problem with the incentives that govern decisionmaking by the management of the insurance agencies and banking regulators. When do they take action with respect to insolvent institutions, and what action do they take?

The banking agencies, "independent" or not, operate in a political framework and are subject to political pressures. For routine closures of scattered small institutions, there is no real problem. But, if insolvency affects a very large institution or a large number of institutions, there will likely be heavy pressures to delay action or to do a bail-out that extends coverage beyond insured depositors.

Either way, the losses for the insurance fund are increased and the incentives at the first level—that is to say, at the level of bank management—are made still worse.

The 1980's make the point, I think, abundantly clear. The savings and loan regulators left hundreds of insolvent institutions under private management for years, throughout the 1980's. Why?

First, initially the administration and then the Congress preferred non-action to facing the problem and providing the resources for closure. As a result, the incentives at the level of bank management could produce an explosion of gambling ventures, many of which were lost.

Second, the bank regulators chose to use so-called P&A (purchase and assumption) transactions in closing out many insolvent banks, including some very large ones. In such transactions, all creditors are fully paid off, which extends the indifference to institutional risk-taking from insured depositors to all creditors and increases still further the subsidy to risk-taking.

So, in conclusion, the lessons to be drawn I think are these:

First, a policy of delay and forbearance will always be more politically appealing than a policy of prompt closure upon economic insolvency. If the closure decision is a discretionary, subjective judgment by the regulators, they are vulnerable to pressure and they will often yield to it.

So, to the extent that any reform proposal relies on agency judgment and discretion, I think it is in trouble. The more objective the judgment and the more mandatory and automatic the prescribed action, the better off taxpayers will be.

Second, if failures are of sufficient magnitude, a policy of complete bailouts is sure to have powerful supporters. Such a policy is a social disaster, creating huge taxpayer costs and vast inefficiencies. Again, it is a mistake to rely on regulators' discretion. Complete bailouts should be contrary to the explicit mandate of the statute.

Now, there are many possible particular approaches to reform and of course I can't attempt to assess them all here at this point. I have tried merely to provide an analytical framework for evaluating them.

I think all of them have some limitations and uncertainties. The perfect single answer does not exist, and the best solution will probably prove to be a combination.

But, in judging proposals or packages, I would urge the committee to keep applying two criteria:

One, how well does it eliminate the present distorting subsidy to risk-taking?

And, two, how little does it depend on bureaucratic discretion in the administration of the scheme and in the closure of insolvent institutions?

Thank you.

[The complete prepared statement of Kenneth E. Scott follows:]

4/27/90

Never Again: The S&L Bailout Bill

by

Kenneth E. Scott *

I. INTRODUCTION

One of the first major domestic problems encountered by the new Bush Administration in January 1989 was the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC) as the Government insurer of savings and loan association (S&L) accounts. During the 1980's, thrift institution failures had skyrocketed from 11 in 1980 to 223 in 1988.[1] The cost to the FSLIC of this wave of failures completely overwhelmed its resources, rendering it insolvent as of the end of 1988 by over $56 billion.[2] At that time there were 365 thrifts, officially estimated to be insolvent under generally accepted accounting principles (GAAP), that were still in operation; the estimated cost of those insolvencies was an additional sum of $38 billion.[3]

The Federal Deposit Insurance Corporation, as the Government insurer of bank deposits, had likewise been experiencing large losses in this same period. Bank failures rose from 10 in 1980 to 200 in 1988.[4] As a consequence, in 1988 the FDIC experienced for the first time an operating loss ($4.2 billion), reducing its fund to $14 billion or approximately 0.8% of insured deposits.[5]

The public attitude of both the Executive Branch and the Congress throughout the 1980's had generally been to deny or minimize the extent of the S&L problem. As one of its first actions, the new Bush Administration in February 1989 recognized that the industry insolvency amounted to at least $90 billion and proposed a plan both to pay the accumulated costs and to prevent such losses in the future.

Under the Administration approach, embodied in the proposed Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),[6] the cost of meeting the insurance obligation and resolving the insolvencies would be financed in part by the issuance of an immediate $50 billion in 30 year bonds, with the Treasury paying the interest costs and making other contributions as needed to the insurance fund over time.[7]

FIRREA also contained provisions intended to address the causes of the massive S&L insolvencies and the collapse of the FSLIC. According to Secretary of the Treasury Nicholas Brady in testifying on the Administration bill: "Two watchwords guided us as we prepared a plan to solve this problem--NEVER AGAIN."[8]

In amended form, the legislation passed the Senate on April 19, 1989,[9] and the House on June 15, 1989;[10] the final version as worked out by the Conference Committee passed both houses and the 400-page bill was signed into law by the President on August 9, 1989.[11]

It is the purpose of this analysis to examine the adequacy of this lengthy and expensive legislation to achieve its stated objective. Does the Financial Institutions Reform, Recovery and Enforcement Act of 1989 in fact "solve the problem" and offer assurance that it will not reoccur? Answering that question involves making some judgments about the causes and conditions that produced the S&L disaster and determining to what extent the new legislation successfully addresses them.

II. CAUSES OF THE FSLIC COLLAPSE

A large number of circumstances and events may be seen as having played some role in a disaster of the magnitude of the current S&L crisis. It is therefore crucial to select the ones most responsible for the final collapse. In this category I would place six factors that are discussed below, in order of chronological occurrence.

A. THRIFTS AS BADLY DESIGNED FINANCIAL INTERMEDIARIES

Although the savings and loan industry in the United States can be traced back as far as 1831, it took its modern form from the Home Owners' Loan Act of 1933, which created a federal savings and loan system regulated by the Federal Home Loan Bank Board (FHLBB).[12] True to their origins, savings and loan associations were to specialize strictly in long term residential mortgage finance within a restricted area around their principal offices,[13] funded by passbook savings accounts which were in practice regarded and promoted as withdrawable at any time.

These institutions therefore of necessity held extremely non-diversified asset portfolios. There was very little sector diversification, since they were heavily concentrated in real estate loans; there was very little geographical diversification, due to the emphasis on local lending territories. Practically all the holdings in the entire portfolio would tend to rise or fall in value together, creating greater swings than if their movements were more independent and offsetting. The result was that these institutions bore a great deal of unnecessary (non-systematic) risk.[14] In the usual business corporation that is not as important a consideration because the stockholders can effectively diversify in their own portfolios, but that was not possible for the FSLIC as the S&L deposit insurer.

The funding structure created a heavy maturity imbalance between long term assets and relatively short term liabilities. If interest rates rose in the economy generally, the cost of funds for S&Ls would move upward rapidly, but the earnings on their assets would adjust only slowly, as loans were gradually paid off and the principal reinvested. The result was that S&Ls were subject to enormous interest rate risk in a volatile economic environment.

Neither of these risks is a necessary concomitant of financial intermediation. A well designed financial intermediary would be permitted, if not required, to diversify its asset portfolio and to minimize any maturity mismatch between its assets and liabilities. The banking system on the whole does not share these unnecessary defects to the same extent as the savings and loan system, and therefore was not to experience as severe problems in the unfavorable circumstances of the 1980's.

Over time, the savings and loan system began to move away from the faulty structure of the 1930s, but at a very slow pace. Correcting the maturity mismatch would mean increasing long term liabilities and short term assets, or engaging in hedging through the use of futures contracts. Some significant movement toward longer term funding came as interest rate ceilings were elevated on certificate accounts in the 1970's,[15] but accounts with a maturity longer than one year amounted to only 27% of deposits as late as September 1980.[16] On the asset side, in April 1981 the Federal Home Loan Bank Board gave federal S&Ls much broader authority to make adjustable-rate mortgages, which can be viewed as essentially short term instruments.[17] Significant broadening of investment powers and lines of permissible business did not occur until the passage of the Garn-St Germain Act of 1982.[18] By then it was too late to help.

B. FLAWS IN THE DEPOSIT INSURANCE SYSTEM

Deposit insurance for banks and S&Ls was instituted by the federal government in 1933 and 1934, originally for a maximum of $2500 per insured account. The insurance premium was set by statute since 1950 at 1/12 of 1% of assessable deposits,[19] and was the same rate for all insured institutions, regardless of the riskiness of their assets or the size of their equity capital or the capability of their management.

The holder of an insured account had no reason to be concerned with the safety or soundness of the particular institution in which he had invested, or to require a higher return commensurate with higher risk. As the deposit insurance ceiling was raised by Congress over the years, practically all accounts at S&Ls were insured.[20] From the standpoint of the management and owners of an insured S&L, this system created a constant inducement to take added risks with their expected higher returns--depositors would not demand higher interest, and the FSLIC could not raise its premium in response.

As a counter to this "moral hazard" (that the existence of the insurance would alter behavior to increase the likelihood of the event--failure--being insured against) there were several possible forces: the prospect of the loss of the institution's own capital, monitoring and restraint of excessive risk-taking by the supervisory authorities, adherence to a policy of immediate closure when the market value of an institution's assets fell below that of its liabilities. Unfortunately, in the S&L case none of these counterforces was very effective.

Historically, the S&L industry had rather low capital; much of the industry was mutual in form and could obtain equity capital only by the accumulation of retained earnings, and regulatory capital requirements were set at fairly paltry levels and lowered whenever enforcement became an issue. The prospect of capital loss from more risky investments was therefore only a modest brake.

Portfolio regulation has been a standard technique of banking law and supervisors, but one on which it would be unwise to place great reliance. Statutory restrictions on permissible activities and investments have been founded at best on rather primitive notions of the riskiness of a particular category; modern portfolio theory, which takes into account the effects of diversification and thus looks to risk of the whole firm, has been consistently ignored.

Even if an institution were to fail, depositors (and hence the deposit insurance corporation) would suffer no or minor loss if closure at the point of insolvency were swift and sure. Insolvency, for this purpose, must be measured in terms of the market values of assets and liabilities. The term is not defined in the statute, however, and was generally defined by the banking authorities in terms of book values, which may greatly exceed market values and are susceptible to a degree of manipulation under generally accepted accounting principles (GAAP) in accordance with management's preferences. In consequence, closure often occurred long after the point of real insolvency.

C. INFLATION OF 1980

With the change of policy by the Federal Reserve Board in October 1979, the nation was to embark upon a period of very high interest rates and then recession, in order to bring to an ultimate end the ever growing inflation that prevailed through most of the late 1960's and the 1970's. By the end of 1980, prime rates went over 20%, mortgage rates exceeded 15% and long term financial assets issued at fixed rates years before underwent large devaluations.[21] The net income of savings and loan associations plunged into the red, and in market value terms the industry was largely insolvent.

The extent of the S&L insolvency at that time has been subsequently estimated by several analysts, Kane and Brumbaugh.[22] Combining their estimates would indicate that the negative net worth of all FSLIC-insured institutions as a group reached approximately $80 billion by the end of 1980 and $110 billion by the end of 1981.[23]

In short, one of the elements of the original defective design--the heavy maturity mismatch between assets and liabilities--had been subjected to precisely the kind of event that would reveal it as fundamentally unsound. The industry as a whole, although perhaps not every institution in it, was massively bankrupt in real terms.[24]

D. ADMINISTRATION RESPONSE

Confronted with the expanding black hole of the savings and loan industry's negative net worth, the response of the outgoing Carter and incoming Reagan Administrations was to look the other way in public and play for time. A variety of techniques was used to achieve those objectives: lowering capital requirements, creating artificial capital, and adopting regulatory accounting principles (RAP) that would inflate the calculation of capital and earnings.

In November 1980, the FHLBB reduced the statutory reserve (capital) requirement, which institutions were supposed to attain after 20 years of insured operation, from 5% to 4% of insured deposits,[25] and in January 1982 further reduced the statutory reserve requirement to 3%, the bottom of the range allowed by law.[26] The minimum figure was removed from the statute altogether in October 1982, leaving the requirement entirely up to regulatory discretion.[27]

New instruments were invented--mutual capital certificates, income capital certificates, and net worth certificates--which were issued by a weak institution and "bought" by the FSLIC with a promissory note; the amount would count as additional capital for the institution and avoid closure, though on a consolidated basis the capital position of the industry and the FSLIC had not been enhanced by a single penny.[28]

Operating losses were reduced by the simple device of adopting new regulatory accounting rules. Losses on the sale of mortgage loans or debt securities were deferred and amortized over lengthy periods;[29] the period for writing off "goodwill" from acquisitions was extended to up to 40 years;[30] office real estate could be written up to an appraised value figure, to create "appraised equity capital."

Both the reduced capital requirements and the tinkering with accounting numbers were part of a policy to avoid closing institutions, even though they were insolvent in market value terms, for as long as possible. It became the general regulatory policy not to put an institution into receivership merely because it was insolvent in an economic sense; closure or other forms of supervisory takeover would not be triggered until the institution showed insolvency in terms of RAP numbers.[31] Thus a 4000-firm industry that was massively insolvent showed only 11 FSLIC-assisted failures in 1980, 28 in 1981, and 63 in 1982.[32]

The reasons for this policy of non-recognition of insolvency by the Reagan Administration are not obscure. The FSLIC's reserves of approximately $6 billion were completely inadequate to deal with an economic black hole on the order of $100 billion or more. Augmenting those reserves would have required the Administration to go to Congress for large appropriations, at the very time that it was seeking to put through the major tax reduction which had been the President's leading campaign commitment.[33] The prospects for enactment of the tax bill would have been severely undermined by a concomitant request for large appropriations that would have dramatically increased the budget deficit.

Furthermore, Treasury officials thought that a program of widespread closure was inappropriate and unnecessary. The insolvency had been created, after all, by high inflation and high interest rates. If the Administration could sharply reduce both inflation and interest rates, as officials firmly believed they could, then the value of those long term mortgages would go back up and the net worth of the savings and loan industry would be greatly enhanced. Thus "forbearance" was the tactic being deliberately followed.

E. MANAGEMENT STRATEGIES FOR INSOLVENT S&Ls

At this point, let us shift perspective from the officials of the federal government to the managers of insolvent institutions that were being allowed to continue in operation. Their choices of an operating strategy may be divided into two basic groups: passive v. active, or trust v. self help.

Passive Strategy

One course for the management of an economically insolvent S&L was to continue a program of traditional lending for home purchase mortgages, and place its faith in God or Fed Chairman Paul Volcker. The hope would be that interest rates would fall dramatically and soon, before monthly operating losses (deriving from the negative spread between old mortgage rates and current cost of funds) ate up even RAP net worth and perhaps forced the supervisory agencies to the point of closure or takeover. The FHLBB clearly cooperated with this strategy, through its accommodating changes in accounting rules and increasing resort to time-buying devices such as net worth certificates.

Active Strategy

A contrasting strategy was for management to rely on its own efforts and investments rather than on the pace and success of the Administration's monetary policy efforts. A self-help strategy would be to obtain substantial new funds and make high expected return (that is to say, high risk) investments to reverse operating losses and pull out of the red. Note that it would be perfectly rational for the management of an insolvent institution to make investments that had high potential payoffs even though the risk of loss might be greater still, since the institution had no real capital of its own left to lose. Under such circumstances, an institution could be led to make even negative net present value investments.

Who would fund such investments? In most businesses that would present a real problem, but it was not a problem for S&Ls following this course. Since these were government insured deposits, there was no difficulty in finding investors. The task was eased by the fact that in 1980 the insurance ceiling was raised from $40,000 to $100,000 per account.[34] Working with brokerage firms, even insolvent institutions could raise almost unlimited funds in the national money market, therefore, by paying the going rate or a little more. Observing this phenomenon, the federal insurance agencies became very concerned about the growth in "broker deposits" at weak banks and S&Ls, so they promulgated restrictive regulations.[35] The regulations were promptly attacked and invalidated by court decision,[36] but money brokers had never been the actual source of the problem; they were just an efficient means whereby management responded to the incentives provided by the risk subsidy of underpriced deposit insurance and a supervisory policy permitting thinly capitalized or insolvent institutions to continue in operation.

Given the funds to employ in a gambling strategy of rapid growth, in what form were they to be invested? The bulk of the industry's growth in deposits and borrowings after 1982 went into the familiar channels of financing residential real estate development or purchasing various kinds of mortgage-backed securities and liquid securities, but about 10% went in new directions.[37] During the 1982-83 period, there was legislation on both the federal and state levels that relaxed long standing portfolio constraints on S&Ls and opened up direct investment in real estate projects, consumer lending and commercial lending.[38]

As it was to turn out, many institutions incurred substantial losses in these new forms of investment, and in consequence many have blamed the S&L disaster on "deregulation."[39] But again, the critics were focusing on more a symptom than a cause of the S&L disaster. Almost all the industry was already insolvent before the arrival of the expanded investment authority. At that point, the core of the problem was to be found in the perverse incentives given management to adopt high risk tactics; there were a multitude of techniques which could be utilized. The new authority provided some novel ones, but there were older methods quite as effective. For example, in a volatile economic environment a program of rapid growth and investment in long term mortgages or mortgage-backed securities is a high risk bet on interest rates. The largest thrift failure, Financial Corporation of America's $31 billion American Savings, provides an excellent illustration of the use (with supervisory blessing) of such a "traditional" technique.[40]

Thus expanded investment authority, or "deregulation," played at most a facilitating role. Deregulation may have made it somewhat cheaper and easier for an institution to obtain more high risk investments, and somewhat harder for regulators to monitor the situation and attempt to take effective countermeasures. But a management responding to strong incentives will not find it difficult to choose a risky course in any form of activity or investment, and examiners coming in after the fact cannot do much to determine the outcome.

Choice of Strategy

Consequently, a situation had been created in which it could be rational for an institution to attempt to grow out of insolvency by seeking high returns on a large volume of new funds placed in risky investments. (From the standpoint of the deposit insurer, of course, that would be a terrible strategy, since some or most of the gains would go to the owners of the institution, while the insurer would bear all the risk and any additional losses.) But a case could also be made for the passive or traditional strategy of continuing residential real estate lending and awaiting a marked decline in inflation and interest rates.

For a particular institution, what determined the choice? It is a pervasive theme of this article that one must be constantly aware of the incentive structure confronting any decision maker. Logically, one would expect the choice to be affected by such factors as the extent of an institution's positive or negative net worth and the extent of the equity interest in the institution held by its controlling management. In a stock institution with a substantial negative net worth in which management held a large equity ownership, there would be strong reasons to choose rapid growth and risky investment. In a mutual institution that was only moderately insolvent, on the other hand, management might sensibly prefer to continue a traditional course.[41]

F. OUTCOMES--THE DRAW FROM THE URN

As individual institutions opted in broad terms for one strategy or the other, results were largely determined by subsequent economic events. Viewed with hindsight, how did each strategy pay off?

For many of those who chose the passive strategy of adhering to traditional practices and slow growth, fate was relatively kind. Inflation and interest rates declined markedly after 1982. By the end of 1984 the aggregate negative net worth for the industry as a whole from interest rate discounts had dropped to perhaps $30 billion,[42] most of it now concentrated in a minority fraction of the industry. By the end of 1988, a positive GAAP net worth of over 6% was reported by 42% of FSLIC-insured institutions, of which 87% also reported operating profits for the year that aggregated $2 billion.[43] In short, although the reported accounting numbers still had to be treated with caution, it appeared that a large part of the industry had been restored to solvency.[44] To that extent, the Administration's gamble (with taxpayers' funds) had paid off.

For many of the institutions which chose the self-help strategy of rapid growth and risky investment, outcomes were not so benign. The mid-1980s brought downturns or outright recession in certain sectors of the economy, such as oil, agriculture and commercial real estate, that were also geographically concentrated in such states as Texas, Oklahoma and California. At this point, the other fundamental design defect in thrift institutions as financial intermediaries--the lack of sector and geographical diversification--was felt with a vengeance. Particularly in the hardest hit states, S&Ls that had bought large volumes of additional funds for high risk investment proceeded, especially after 1984, to incur huge losses.

The losses from the gambling strategy were obviously aggravated by the fact that the supervisory authorities continued to follow a "forbearance" policy, but now for reasons that derived more from Congress than from the Administration. In 1985 the FSLIC, through FHLBB Chairman Gray, sought $15 billion in additional capital to enable it to close insolvent thrifts. The U.S. League of Savings Institutions, the industry's principal lobby, opposed the request as grossly excessive in amount, and an assortment of individual institutions (especially in Texas) claimed to be the innocent victims of arbitrary treatment and supervisory vendettas. Congress as usual was more responsive to constituents and contributors than to agency bureaucrats.[45] The legislation, not enacted until August 1987, allowed only $10.8 billion in additional funding (from borrowings spread over 3 years) and contained elaborate procedural "safeguards", accounting rules, and special capital requirement provisions, all intended to make closures less likely.[46] Once again, as losses and insolvencies mounted, a policy of limited (and inadequate) response was deliberately adopted.

In a fair number of these institutions, the losses were exacerbated to some extent by fraud and theft. Both the industry and supervisory authorities have found it convenient to try to create the impression that much of the enormous aggregate loss is due to fraud. Thus officials have made various statements to the effect that failure was a "direct result" of fraud in 20%[47] of a selected set of institutions, or that "fraud and insider abuse" was "involved" in 25% to 30% of failures,[48] or was "a factor" in 75% of the failures[49] or was "discovered" in 60% of the seized institutions.[50] At the same time, they have been careful to note that very little could be expected to be recovered from all the criminal and civil actions against those guilty of fraud.[51]

It seems to me probable that only infrequently was outright theft a deliberate strategy employed from the start on a large scale by the management of a thrift institution; fraud appears more often to have been either a relatively minor ingredient in the total loss or a desperate final period expedient as management struggled to keep a failed institution afloat a while longer or gave up and looted it.[52] There are many types of fraud and degrees of associated loss, so that the timing and importance of such behavior could be assessed only by a systematic empirical study focused on the issue--which neither the banking agencies nor anyone else has ever undertaken and published.[53]

III. SOLVING THE PROBLEM

By the end of the 1980's, the combination of circumstances and events described above in Part II had produced the insolvency of hundreds upon hundreds of financial institutions. The official cost estimates cited in Part I are impressive but almost surely on the low side. Outside observers have suggested that the present value cost of existing insolvencies is in the range of $120 billion to $150 billion,[54] and when financed over 30 years the total outlays will amount to more than $300 billion.[55]

The Bush Administration, in confronting this disaster, therefore had to deal with the twin issues of paying off the existing agreements and insurance obligations of the FSLIC and preventing the dismal tale from being repeated at some future date. Much of the controversy over the bill and its enactment concerned the first issue: whether the initial bond flotation would be sufficient in amount, whether the principal repayment of the financing bonds should come from the industry (via a levy on the Federal Home Loan Bank System) or from the U.S. Treasury, and whether the expenditure would be kept outside the Gramm-Rudman-Hollings deficit calculation by timing or definition or waiver.[56] Those topics are outside the purview of this paper.

The concern here is with exactly what the legislature attempted to do to make sure that the S&L fiasco would not reoccur. The analysis in Part II identified six key factors in the creation of the massive losses which overwhelmed the FSLIC--what was, or should be, done about them?

A. THE FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989

Two of the six factors identified in Part II lie outside the domain of direct Congressional control. Monetary policy and inflation rates derive, not from Congressional enactments, but from the conduct of policy by the Federal Reserve Board and the Department of the Treasury. That is not to say that Congress has no role in the matter; it is in charge of revenues and appropriations and it created the legal framework within which monetary policy is conducted. But for our purposes, it seems fairer to regard inflation and the business cycle as not simply matters of Congressional choice.

Likewise, whether individual investments turn out to have favorable or unfavorable outcomes may be regarded, for our purposes, as exogenous. All investment is associated with some degree of risk, and no legislation can or should undertake to eliminate risk from the asset portfolios of financial intermediaries. There is always uncertainty as to future events, and an institution can always experience a run of bad luck that was not to be expected.

But that leaves four other factors that lie more directly under the control of Congress and the Administration: the design of financial intermediaries, the design of the deposit insurance law, the rules governing the response of the banking agencies to institutional insolvency, and the regulations bearing on the ability of an institution to attempt a gambling strategy. On each of these, what does FIRREA have to say and contribute?

The Design Flaws of Thrifts as Financial Intermediaries

It has been pointed out that the underlying weaknesses in savings and loan associations are their lack of diversification in portfolio assets and their mismatch in maturities of assets and liabilities. The trend over the last two decades has been one of gradual movement to correct those structural weaknesses; FIRREA reverses that trend, particularly as to asset diversification.

The underlying concept of FIRREA seems to be that, in line with the justification for their existence, S&Ls should be forcibly returned to the "safe" traditional role of being heavily concentrated in residential real estate. This is exemplified in two ways. The "qualified thrift lender" (QTL) test that S&Ls must meet to obtain access to low-interest Federal Home Loan Bank advances is made more stringent. FIRREA raises from 60% to 70% the percentage of portfolio assets that must pertain to home finance,[57] and narrows the categories of assets that may be counted toward another 55% threshold.[58] This provision mandates asset concentration directly.

Other provisions promote asset concentration indirectly. For example, "junk" (non-investment grade) bonds can be an easy and inexpensive device for diversifying lending both geographically and by sector; FIRREA prohibits all such investment by thrifts in the future.[59] Likewise, federal thrifts are limited in the amount of their loan portfolio that can be invested in commercial (as opposed to residential) real estate to four times their capital (cut from 40% of assets).[60] State-chartered thrifts are restricted to the amount of direct investment in real estate or other equity positions that is permitted to federally chartered thrifts, which at present does not amount to very much (basically 3% of assets, via a service corporation),[61] and to only those lines of business permitted federal thrifts (unless the FDIC finds the activity poses no significant risk of loss).[62]

The general tendency of the legislation, therefore, is to move S&Ls away from becoming more broadly diversified intermediaries comparable to banks and back toward being narrowly specialized residential real estate institutions.[63] The illusion that, contrary to the tenets of modern portfolio theory, this would make them "safer" seems hard to kill.

The Design of a Deposit Insurance System

One fundamental defect in the present deposit insurance scheme lies in the mispricing of the insurance premiums, set at the same rate for institutions of widely varying risk. The result was a subsidy and incentive for risk-taking by insured institutions, which increased in amount and strength as the institution's own capital diminished.[64]

FIRREA raises the level of the insurance assessment, from the present basic figure of 1/12 of 1%[65] or 8.3 basis points to a new norm of 0.15% or 15 basis points, with provisions that would permit a rate as high as 32.5 basis points if the insurance funds are experiencing losses.[66] But the premium rate remains fixed across all institutions, so the perverse risk incentive feature is unaltered. Some unease on that score is evidenced by provisions calling for further studies of the deposit insurance system by the Treasury and the GAO.[67]

Administrative Forbearance and Delay

The new law does make some contribution toward rendering less likely a repetition of the disastrous policy of FSLIC in not recognizing market value insolvency and leaving insolvent institutions able to continue under prior control. On the accounting front, for instance, only limited amounts of "intangible" assets could be counted toward meeting core capital requirements; existing "goodwill" from supervisory mergers would not count after 1994.[68] The notorious "loan loss deferral" account as an asset would be indirectly eliminated, since it does not conform to the standards required for national banks.[69] The whole subject of accounting standards is to be reviewed and reassessed by each of the banking agencies within a year.[70]

As the new administrator of the S&L insurance fund, FDIC is now permitted, by administrative action and without hearings, to suspend deposit insurance with respect to those institutions whose tangible capital falls to zero.[71] While such action will be subject to subsequent judicial review, it will give the insurer in substance something tantamount to the power to close an insolvent institution--a power which is otherwise possessed not by FDIC but by the primary chartering authority (federal or state). The FSLIC and the FDIC have always had the power to terminate deposit insurance,[72] but the procedure was time consuming and rarely even contemplated.

Authority to act, of course, does not prevent inaction. The legislative provisions for early intervention would in no way rule out the adoption by the insurer of a deliberate policy of non-recognition and forbearance, such as was in effect during the 1980s. Nowhere does the new law even define the concept of "insolvency" to be adopted by the supervisors--in terms of market values, book values (under GAAP or RAP), or whatever--leaving them as free as before to follow the dictates of political prudence.

Management Choice of a Gambling Strategy

If accounting standards are not rigorous and not based on market values to the maximum extent attainable and if supervisory authorities do not follow a uniform policy of prompt closure when institutions are insolvent or near-insolvent in real terms, then opportunities will reoccur for the owners of an institution to adopt high growth-high risk strategies. The legislation can be seen as addressing this threat along two main lines.

First, higher capital requirements are designed to make sure that the owners have more of their own money at stake and less of an opportunity to take risks at the insurer's expense. The legislation leaves the precise determination of capital standards for thrifts to the regulators, subject to some statutory minimums, including a provision that the risk-based capital standards for S&Ls cannot after 1990 be "materially" below those required for national banks.[73] Under current banking rules, that would refer to a minimum ratio of GAAP capital to risk-adjusted assets of 7.25% in 1991 and 8% by 1993; since residential mortgage loans are given the special treatment of counting for only half their amount, for S&Ls those capital ratio figures are cut approximately in half in real terms.[74] In addition, a ratio of "tangible" capital to assets of at least 1.5% is required.[75]

As the FHLBB found out in the early 1980s, capital may be required by regulation but not exist in reality. When the reality is one of non-compliance, what is the supervisor or insurer supposed to do? One answer is to issue "capital directives" under the International Lending Supervision Act of 1983[76] and the Competitive Equality Banking Act of 1987,[77] which carry sanctions that are ultimately judicially enforceable if the institution does not comply. But only a solvent institution can raise additional equity in the private capital markets; an insolvent institution will find the directive impossible to meet.

In any event, the whole procedure affords opportunity for disputation and delay. What if management chooses to use whatever time it sees remaining when it nears insolvency to embark upon the now only too familiar course of rapid growth (generating up-front fee income which may ultimately be lost in loan defaults) and high expected return investments? The legislation has several provisions that relate to this possibility. Thrifts that do not meet the new capital standards after 1990 will be restricted in asset growth; at most, the agency can permit growth limited to the amount of interest that is credited on their deposits.[78] Likewise, such institutions may face a general prohibition on accepting brokered deposits.[79] In this manner, the supervisory agencies may attempt to cut off a high risk, rapid growth strategy. But it will still be possible for management to drastically change the risk profile of an institution without new funds by a massive program of asset disposition and reinvestment. The limitation on that course is that it may trigger the recognition of existing portfolio losses to such an extent as to make evident the institution's lack of real capital.

B. EFFECTIVE REFORM

To evaluate the modifications effected by FIRREA, they must be compared to the essential ingredients of an effective reform. Radically changing the asset and liability structure of savings and loan associations could certainly contribute a great deal toward making them less vulnerable to unfavorable economic conditions, but that alone would not go far enough.

The point may be clarified by comparing the S&L industry to the banking business, in the adverse circumstances of the 1980s. Banks had markedly better portfolio diversification in terms of sector concentration but were often not so much better off in terms of geographical concentration, due largely to a set of archaic legal rules impeding nationwide branching and lending. Banks also did not have the acute maturity mismatch that afflicted S&Ls. The result was that, while banking suffered from numerous failures, the strains on that industry and the FDIC were not as severe as those on the S&Ls and FSLIC.

But even a more soundly designed system of financial intermediaries must expect that from time to time it will experience difficult economic times and numerous failures. The question then becomes one of the magnitude of the losses that such adverse times will create for the deposit insurance funds.

For the deposit insurance system to be viable, even waves of failure must not be permitted to occasion the enormous losses that the FDIC and FSLIC are currently experiencing. The magnitude of those losses, it has been argued in this article, was occasioned by a literal explosion from 1983 on of what economists refer to as the problem of moral hazard. Uniformly priced deposit insurance constitutes a subsidy to risk taking by thinly capitalized institutions and induces extreme risk taking by the owners of insolvent institutions, as noted in Part II E above. And when confronted with a wave of insolvencies, it may seem politically advantageous to avoid prompt closure and postpone the day of reckoning to better times or a subsequent Administration, as noted in Part II D above.

Economic downturns will always produce some failures and severe conditions may produce many failures, but the huge losses that have been experienced were the consequences of perverse incentives that shaped the decisions of both the management of S&Ls and banks and the management of the insurance funds. In short, the key to effective reform is to change that incentive structure for the future.

Bank Management and Owners

For bank managers and owners, the objective and test of effective reform should be to take away the subsidy to risk taking that is inherent in the present system of bank regulation and deposit insurance. There are a number of ways in which that might be undertaken, which will be only briefly developed here.[80]

One alternative would be to require that insured accounts be fully collateralized by a pool of actively traded securities. The regulatory role of the deposit insurer would be reduced to monitoring observance of the collateral requirement on a daily basis, which would not be difficult since security values would be easily available from the trading in secondary markets. If the necessary collateral was not maintained, the insuring agency would put the institution into immediate receivership and would be responsible for payment of all accounts; losses from the liquidation of the collateral pool should not be extensive.[81] The consequence for banks and S&Ls would be that holdings of non-traded (or non-securitized) commercial and household loans would have to be funded with non-insured borrowings or investment accounts.

A second approach would be to try to reduce the probability of insolvency by requiring depository institutions to meet higher capital requirements. This is the course being taken by the United States and other major industrialized nations under the Basle Accord of July 1988.[82] That agreement calls for the major international banks in a group of 12 countries to attain an 8% capital-asset ratio by the end of 1992.[83] The calculation of the ratio involves numerous adjustments for the risk categories to which assets are assigned. With sufficient capital, deposits become less risky and the subsidy element in the existing U.S. deposit insurance system would be diminished or perhaps eliminated.

No matter what the initial capital level of a bank, however, adverse events may rapidly reduce that level or exhaust it entirely. A third approach to deposit insurance reform therefore places its greatest emphasis on minimizing the loss encountered in the event of insolvency by stressing early intervention and closure by the banking authorities.[84] If an institution is closed at or shortly before the point at which the market value of its assets falls below the value of its liabilities, the losses to the insuring agency should be limited to those associated with the administrative costs of a receivership or liquidation. For that to be true, though, the action must be taken with respect to market values and not accounting or book values. Not all assets of a bank or S&L are traded on secondary markets, and therefore elements of judgment (and the possibility of error) will enter into the determination. Market value accounting and reporting can, however, be carried much farther than it has been to date,[85] and the objective of making supervisory decisions on the basis of market values could be made official agency policy--which is not now the case.

A fourth approach would have the federal deposit insurance system mimic much more closely the practices of private insurers. That would imply a number of changes. Moral hazard would be restrained by a greater use of co-insurance and deductibles--for example, by significantly lower account insurance ceilings and abolition of de facto 100% coverage in assisted mergers or purchase-and-assumption transactions. Insured institutions could be classified according to risk and charged correspondingly different premiums, ending the present regime of statutorily restricted and uniform premium rates. Judgments as to institutional risk and appropriate premium levels might be taken from private market sources, if the needed markets were developed.[86]

None of these approaches is free from difficulties and limitations in implementation, and the practical issue may be one of finding the optimal mix of these strategies, rather than choosing one on which to place sole reliance. But serious consideration of the problem at the Congressional level has hardly begun.

Agency Management

Under our existing bank regulation and deposit insurance system, it is not only the management of the financial institution that is operating under incentives that are quite perverse from the standpoint of the federal taxpayer. That is also true of the management of the banking supervisory agencies. When confronted with a correlated wave of insolvencies and the prospect of putting numerous institutions out of business, it often seems to be expedient to forego immediate action and hope that things may get better. The owners of insolvent institutions obviously have an incentive to apply political pressure through their Congressional representatives for "forbearance"--that is, more time to gamble with the money of the insurance corporation or taxpayers.[87] And if the failure is large enough to exhaust the resources of the insurance corporation and require Congressional appropriations, as was the case for the FSLIC, the advantages of delay can seem compelling. Presidents and members of Congress hold office, after all, for quite limited terms on the average. From a political standpoint, a cost postponed is a cost in part or in whole avoided.

Thus, from the taxpayers' point of view, there is a need to try to change the political and administrative incentives as well. That is not an easy task, but it is not altogether impossible. When looked at from the standpoint of Congress, the problem is that an industry is able to organize through trade associations to lobby the Congress, while taxpayers are too diffuse to have any equally effective organization. Recognizing this reality, it would be possible to rebalance the political forces bearing on Congress only by creating some conflicting lobbying pressure.

An interesting intimation as to how that might be done may be found in the new bill. To counteract any incentive for a bank or S&L holding company with multiple insured institutions to game against the FDIC by transferring bad assets to one insured institution and preserving the others, the legislation creates a cross-guarantee provision making all of the affiliated insured institutions liable to the FDIC for each other's losses.[88] The joint liability provision thereby neutralizes an adverse incentive. The joint liability concept is raised to the industry level in the premium provision, which would for the first time give the insurance corporation authority over time to more than double (from 15 to 32.5 basis points) the premium rate when it is encountering losses.[89] Presumably, the statutory potential for increased premium costs will give banks or S&Ls an incentive to be concerned over the more risk-prone of their brethren, thereby altering the lobbying stance of their industry. The same concept could be carried to a still higher level, if the separate bank and S&L insurance funds were combined. The prospect of underwriting losses in the competing industry might on occasion set the American Bankers Association and the United States League of Savings Institutions in active opposition to each other--to the taxpayers' benefit.

Another way in which to try to change the political calculus of agency decision making could be contained in the terms of the legislation which the agency is charged with administering. If the statute gives the agency broad discretion in interpretation or action, it can be expected that members of Congress or the Administration will try to exert pressure on the agency when it is contemplating steps that would adversely affect politically influential constituents. Unusual attention was drawn to this process in the investigation of Speaker James Wright, which revealed the extraordinary lengths to which he was prepared to go on behalf of some of his S&L supporters.[90]

The greater the agency's statutory discretion, the more vulnerable it is to that type of pressure. That becomes a consideration in choosing among the alternatives discussed in Part III B above. To the extent that reliance is placed upon matters of agency judgment, such as determination of market values of non-traded assets or the appropriate degree of response to a required capital deficiency, susceptibility to political pressure is also created. A rule of full collateralization, on the other hand, coupled with a statutory injunction that non-compliance means prompt closure, leave little room for political maneuver. Administrators and politicians generally extol the virtues of discretion and flexibility, but in this context the taxpayer may be much better served by inflexible rules that are more likely to be observed.

IV. CONCLUSION

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 will impose huge costs on the taxpayers to settle the insurance obligations of the FSLIC. This episode is easily the largest financial disaster in a government program in the history of the United States. The official figures from the Treasury Department contemplate outlays of $50 billion at the outset and aggregate costs in the first 10 years, under a set of highly favorable assumptions, of $166 billion.[91] The General Accounting Office arrived at a total cost over 30 years of $285 billion, and others have suggested even larger numbers.[92] Nonetheless, even this massive program will not suffice to resolve the S&L debacle. At some point, additional funds are going to have to be provided to meet the losses that already exist.[93]

No one would wish to repeat such a dreary experience. To assess what FIRREA has done to address the causes of the FSLIC collapse, it is necessary to try to understand the essential factors that produced such a result. That analysis was undertaken in Part II, and then used in Part III to evaluate the contributions of the Act. On that basis, readers can arrive at their own assessment. In my view, the Act makes modest improvements in the area of capital requirements, but their administration and effectiveness are yet to be determined and there is every reason based on history to be skeptical. The structural deficiencies of the S&L industry do not seem to be sufficiently appreciated, and the incentive problem (for the managers of both insured institutions and the insurance funds) at the core of effective reform has not really been perceived and forcefully addressed.

Returning to Secretary Brady's testimony, a more modest but more accurate slogan for this bill might have been "Never Again --In This Administration." And even that may require more than a bit of good fortune.

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1. J. Barth and M. Bradley, Thrift Deregulation and Federal Deposit Insurance, 2 J. Fin. Services Research 231, Table 7 (Sept. 1989). Failures are defined as liquidations, mergers and other resolutions involving FSLIC assistance. During 1989, 44 more such failures were resolved. By the end of 1989, there were 285 savings and loans in conservatorship pending resolution, with an additional 223 insolvent S&Ls expected to be placed in conservatorship. See Wall St. J., Jan. 11, 1990 at A16.

2. U.S. General Accounting Office, Bank and Savings and Loan Insurance Funds: Financial Condition and Proposed Reforms. Statement of Frederick D. Wolf, Assistant Comptroller General, Before the House Comm. on Banking, Finance and Urban Affairs 10 (GAO Doc. No. GAO/T-/AFMD-89-3, Mar. 10, 1989). By the time it was closed out in August, 1989, FSLIC's accumulated losses had reached $87 billion. N.Y. Times, Apr. 7, 1990, at 1, col. 1.

3. Problems of the Federal Savings and Loan Insurance Corporation [FSLIC]: Hearings Before the Sen. Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 275, 284 (statement of M. Danny Wall, Chairman, FHLBB).

4. FDIC, 1988 Ann. Rep. 61, Table 122. There were 206 bank failures in 1989.

5. Id. at xvi.

6. H.R.1278 (March 6, 1989) and S.413 (February 22, 1989), 101st Congress, 1st Session.

7. The U.S. General Accounting Office estimated the total cost over the 30 year period to be $285 billion. See Financing the S&L Rescue Package: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. 80 (1989) (statement of Frederick D. Wolf, Assistant Comptroller General).

8. Administrations Plan to Resolve the Savings & Loan Crisis: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. 66 (1989) (statement of Nicholas F. Brady, Secretary of the Department of the Treasury).

9. 135 Cong. Rec. S. 4238 (1989).

10. 135 Cong. Rec. H. 2606 (1989).

11. Public Law 101-73 (August 9, 1989).

12. Act of June 13, 1933, Ch. 64, § 5, 48 Stat. 132, 12 U.S.C.A. § 1464 (West 1989).

13. National Housing Act of 1934, Ch. 847, tit. 4, § 403, 48 Stat. 1257, 12 U.S.C.A. § 1726(b) (West 1989).

14. For further development of the theory of portfolio covariance, see, e.g., Thomas E. Copeland and J. Fred Weston, Financial Theory and Corporate Policy 198-199 (3d ed. 1988).

15. See 12 C.F.R. §§ 526.2-526.5-1 (1972), 12 C.F.R. §§ 526.2-526.5-1 (1978), 12 C.F.R. §§ 526.2-526.3-1 (1981).

16. See Statistical Division, Office of Policy and Economic Research, Federal Home Loan Bank Board, Savings & Home Financing Source Book 52 (Table 28) (1981).

17. 46 Fed. Reg. 24, 148 (1981).

18. Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, §§ 321-325, 328-330, 96 Stat. 1469, 1499-1502, 12 U.S.C.A. § 1464(c) (West 1989).

19. See 12 U.S.C. § 1717(b)(1) and § 1817(b)(1).

20. By 1943 more than 93% of S&L savings were insured, and the percentage continued to rise. See K. Scott and T. Mayer, Risk and Regulation in Banking, 23 Stan. L. Rev. 857, 876 (Table 1) (1971).

21. As an example, take a fully-amortizing 25 year mortgage made at the end of 1975 at an interest rate of 9%, the average then prevailing. Even putting aside adverse shifts in prepayment possibilities or in the borrower's credit risk, that loan would in the 15% world of late 1980 be subject to a market discount of about 32%.

22. E. Kane, The Gathering Crisis in Federal Deposit Insurance 102 (1985); D. Brumbaugh, Thrifts under Siege 50 (1988); E. Kane, The S&L Insurance Mess: How Did It Happen? 75 (1989).

23. Data on total assets of FSLIC-insured institutions come from U.S. League, Savings Institutions Sourcebook 49 (Table 57) (1989).

24. According to former FHLBB Chairman Richard Pratt, "by 1982 . . . virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates." Final Oversight Hearings on the Savings and Loan Industry in the 100th Congress: Hearings Before the Sen. Comm. on Banking, Housing and Urban Affairs, 100th Cong., 2d Sess. 128 (Aug. 3, 1988).

25. FHLBB, Net Worth Amendment, 45 Fed. Reg. 76,111 (Nov. 6, 1980).

26. FHLBB, Net Worth Amendment, 47 Fed. Reg. 3,543 (Jan. 26, 1982).

27. Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 203(d), 96 Stat. 1469, 1493, 12 U.S.C.A. § 1726(b) (West 1989).

28. Cf. U.S. General Accounting Office, Net Worth Certificate Assistance Programs: Their Design, Major Differences, and Early Implementation 37-45 (GAO Pub. No. GAO/GGD-85-8, 1984).

29. FHLBB, Treatment of Gains and Losses on the Sale or Other Disposition of Mortgage Assets, Mortgage-Related Securities, and Debt Securities, 46 Fed. Reg. 50,048 (Sept. 30, 1981).

30. FHLBB, Treatment of Goodwill Acquired in Mergers, 46 Fed. Reg. 42,274 (Aug. 13, 1981).

31. See Telegraph Sav. and Loan Ass'n v. Federal Sav. & Loan Ins. Corp., 564 F.Supp. 862 (N.D. Ill. 1981), aff'd, 703 F.2d 1019 (7th Cir.), cert. denied 464 U.S. 992 (1983).

32. See Barth and Bradley, supra note 1, Table 7.

33. Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172 (Aug. 13, 1981).

34. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, tit. 3, § 308(b)(1)(B), 94 Stat. 132, 147 amending 12 U.S.C.A. 1728(a) (West 1989).

35. See, e.g., Brokered Deposits; Limitations on Deposit Insurance, 49 Fed. Reg. 13,003, 13,011 (April 2, 1984).

36. See FAIC Securities, Inc. v. United States, 595 F.Supp. 73 (D.D.C. 1984), aff'd, 768 F.2d 352 (D.C. Cir. 1985).

37. Of approximately $890 billion of net funds that FSLIC-insured institutions obtained in the 1983-85 period, about $90 billion went into non-mortgage loans and other assets. FHLBB, 1986 Ann. Rep. 6 (Table 1).

38. For federal legislation, *see* Garn-St Germain Act, *supra* note 18. For state legislation, *see*, *e.g.*, Savings Associations Law, 1983 Cal. Stats., c. 1091, § 2; Cal. Fin. Code §§ 6503, 7252, 7450-54 (West 1989).

39. This is the S&L industry's preferred explanation, as exemplified in N. Strunk and F. Case, *Where Deregulation Went Wrong* (U.S. League of Savings Associations 1988). For a critique, see the review by A. Harrell, 42 Consumer Fin. L. *Q. Rep.* 216 (1988).

40. *See*, *e.g.*, Los Angeles Times, Feb. 11, 1988, Part 4, at 1, col. 1.

41. The question can only ultimately be clarified by an empirical investigation. Such a study is now being undertaken by the author and Dr. James Barth, Director of the Office of Policy and Economic Research at the Office of Thrift Supervision.

42. *See supra* note 22.

43. Data from Office of Policy and Economic Research, Federal Home Loan Bank Board.

44. The same pattern appears in the most recent profit data, for the fourth quarter of 1989. There were 1818 institutions that reported a profit ($1.3 billion); 485 insolvent institutions either in or scheduled for conservatorship reported operating and writedown losses of $6.5 billion, and 581 other institutions had losses of $1.3 billion. For the entire year 1989, the industry as a whole lost $19.2 billion. N.Y. Times, March 27, 1990 at 1, col. 6.

45. For an excellent account and analysis, see T. Romer and B. Weingast, *Political Foundations of the Thrift Debacle* (unpublished manuscript April 1990).

46. Competitive Equality Banking Act of 1987, Pub. L. 100-86 (Aug. 10, 1987), Titles III & IV; 12 U.S.C.A. Secs. 1441, 1442a, 1437 note, 1730a(m), h, i (West 1989).

47. Problems of the Federal Savings and Loan Insurance Corporation [FSLIC]: Hearings Before the Sen. Comm. on Banking, Housing, and Urban Affairs, Part I of IV, 101st Cong., 1st Sess. 299 (Feb. 9, 1989) (statement of Attorney General Thornburgh).

48. *Id.* at 314 (statement of Senator Shelby).

49. Id.

50. N.Y. Times, Apr. 12, 1990 at 1, col. 4 (statement of Chairman Seidman).

51. See supra note 47 at 306 (statement of Attorney General Thornburg).

52. Colorful accounts of management enrichment and political and criminal involvement are provided in J. Adams, The Big Fix (1989), P. Pilzer and R. Dietz, Other People's Money (1989) and S. Pizzo, M. Fricker and P. Muolo, Inside Job (1989).

53. An effort to include fraud as one determinant of resolution costs may be found in J. Barth, P. Bartholomew and C. Labich, Moral Hazard and the Thrift Crisis: An Analysis of 1988 Resolutions in Fed. Res. Bank of Chicago, 25th Ann. Conf. on Bank Structure and Competition ___ (Table 6) (1990) and 44 Consumer Fin. L. Q. Rep. 22 (1990). A more general discussion of methodology is given in G. Becker, Crime and Punishment: An Economic Approach, 76 J. Pol. Econ. 169 (1968).

54. See, e.g., Financing the S&L Rescue Package: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. 96 (June 1, 1989) (statement of Bert O. Ely).

55. See, e.g., 47 Cong. Quart. 2113 (Aug. 23, 1989). More recently, Comptroller General Bowsher estimated the 30 year outlays at between $325 billion and $500 billion. N.Y. Times, Apr. 7, 1990 at 1, col. 1.

56. See, e.g., Wall St. J., July 21, 1989, at 1; 47 Cong. Quart. 2115 (Aug. 12, 1989).

57. Home Owners' Loan Act of 1933 (hereafter HOLA), § 10(m)(1)(A) as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73 (hereafter FIRREA), § 303(a). In this category of "qualified thrift investments," however, up to 5% may be consumer loans.

58. HOLA § 10(m)(4)(C)(iv), as amended by FIRREA § 303(a).

59. Federal Deposit Insurance Act (hereafter FDIA), § 28(d)(1), as added by FIRREA § 222.

60. HOLA § 5(c)(2)(B)(i), as amended by FIRREA § 301.

61. 12 U.S.C.A. § 1464(c)(4)(B) (West 1989).

62. FDIA §§ 28(a),(c) as added by FIRREA § 222.

63. S&Ls would, however, be made subject to the national bank limitation on loans to a single borrower: 15-25% of capital, depending on security collateral. See 12 U.S.C.A. § 84 (West 1989).

64. See K. Scott, The Defective Design of Federal Deposit Insurance, 5 Contemp. Policy Issues 92 (Jan. 1987).

65. S&Ls have been paying a "supplemental" assessment of 1/8 of 1%. 12 U.S.C. § 1727(c).

66. FIRREA § 208, amending FDIA § 7, 12 U.S.C. § 1817(b)(1).

67. FIRREA §§ 1001, 1003.

68. HOLA § 5(t)(3)(A) as amended by FIRREA § 301.

69. HOLA § 5(t)(1)(C) as amended by FIRREA § 301. There is a Congressionally-mandated exception for agricultural loans: 12 U.S.C.A. § 1823(j) (West 1989).

70. FIRREA § 1215.

71. FDIA § 11, 12 U.S.C. § 1818(a)(8)(A) (1982), as added by FIRREA § 926.

72. 12 U.S.C. §§ 1818(a), § 1730(b) (1982).

73. HOLA § 5(t)(2)(C), as amended by FIRREA § 301. The statute would have made applicable to S&Ls by the end of 1989 the national bank leverage ratios of 5 1/2 or 6% capital to total assets, which most S&Ls would have failed; the Comptroller of the Currency promptly moved to lower the bank leverage ratio to 3%. 54 Fed. Reg. 46,394 (Nov. 3, 1989). See Wall St. J., Sept. 7, 1989, at A3, and Sept. 11, 1989, at A2. Even at the 3% level, about 800 S&Ls (or 30% of the 'solvent' part of the industry) still failed the test. Id. Nov. 7, 1989, at A5.

74. 12 C.F.R. Part 208 App. A (1990).

75. HOLA § 5(t)(2)(B), as amended by FIRREA § 301.

76. International Lending Supervision Act of 1983, Pub. L. No. 98-181, § 908, 97 Stat. 1280 (1983), 12 U.S.C. § 3907.

77. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86 (1987) § 40618, 101 Stat. 615, 12 U.S.C. § 1730(t).

78. HOLA §§ 5(t)(6)(B)&(C), as amended by FIRREA § 301.

79. FDIA § 29(a), as added by FIRREA § 224(a).

80. For an extended discussion, *see* K. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 Bus. Law. 907 (May 1989).

81. *See* Brookings Institution, Blueprint for Restructuring America's Financial Institutions: Report of a Task Force 23 (1989).

82. Comm. on Banking Regulations and Supervisory Practices, Bank for International Settlements, *Final International Risk-Based Capital Standards Adopted by the Basle Committee on Banking Regulations*, 51 Banking Rep. (BNA) No. 4, at 143 (July 25, 1988). For discussion, *see* Norton, *Reflections on the New Risk-Based Guidelines for Banking Institutions*, 43 Consumer Fin. L. *Q. Rep.* 74 (1989)

83. *Id.* at 149, 150.

84. *See* G. Benston & G. Kaufman, Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options. (Salomon Bros. Center for the Study of Financial Institutions and Graduate School of Business Administration at New York University Monograph Series in Finance and Economics No. 1, 1988). *See also* Shadow Financial Regulatory Committee, Statement No. 41, An Outline of a Program for Deposit Insurance and Regulatory Reform (Feb. 13, 1989).

85. For example, even traded securities are presently carried at historical cost, except for marketable securities held as short term investments or in trading accounts. *See* Financial Accounting Standards Board, Accounting Standards: Original Pronouncements, Statement of FAS No. 12, p. 86 (1989). Some extension of market pricing is currently being proposed. *See* N.Y. Times, Nov. 21, 1989, at C1.

86. For discussion of these measures, *see* Scott, *supra* note 64.

87. *See*. *e.g.*, N.Y. Times, Sept. 16, 1989, at 17, col. 3 and Oct. 27, 1989, at A1 (describing efforts of Senators Cranston, De Concini, Glenn, Riegle and McCain on behalf of Lincoln S&LA).

88. FIRREA § 206(e).

89. FIRREA § 208(4).

90. House Committee on Standards of Official Conduct, Report of the Special Outside Counsel in the Matter of Speaker James C. Wright, Jr. 192-278 (Feb. 21, 1989).

91. See, e.g., Los Angeles Times, Aug. 4, 1989, Part 1, at 1, col. 2.

92. See, e.g., 47 Cong. Quart. 2113 (Aug. 12, 1989) ($300 billion). The GAO has now revised its upper bound estimate to $500 billion. See supra note 55.

93. The Congressional Budget Office has already estimated that another $15 billion will be needed. See Wash. Post, Aug. 23, 1989 at B1. FDIC Chairman Seidman has stated that the $50 billion may be insufficient, in testimony before the Senate Banking Committee. See N.Y. Times, Oct. 5, 1989, at C1.

Senator DIXON. Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. I hesitate to impose this way, Mr. Chairman, but I have a number of Illinois Congressmen coming over to my office about now for a major project and I have to go there. And I'd just love to get one question off my mind before I leave.

The CHAIRMAN. Please do.

Senator DIXON. Would my colleagues all indulge me?

Thank you, Mr. Chairman.

Mr. Scott, I agreed completely with what you said. I apologize to Mr. Connell and Mr. Ely for not hearing what they said. And I'd like to make this observation and see what your response is because, first of all, I think there are a lot of others here, and particularly on this committee, that view this exploding thrift crisis and the related crisis we see on the horizon in financial institutions as the major domestic problem in the country.

I mean, you talk about the budget. It's important. But, if we don't get this solved, it is going to impact the budget. It's going to impact interest rates. And I think it's just the biggest domestic crisis in a long, long time.

And so I think what you've said is of great value.

I wanted to make this observation and see what you think.

We had Federal deposit insurance for years in the FSLIC and everything, and that was fine. But there wasn't any risk out there. Now, my recollection is about a half-a-dozen banks were failing every year in the 1950's and 1960's. So, in essence, you know, you had insurance system but no risk.

Since the late 1970's, particularly throughout the 1980's, there's been this increasing risk going on all the time. And it occurs to me that the heart of what you said is the problem here.

Now we've got this tremendous risk out there and we've got an absolutely inadequate deposit insurance system dealing with it. And I think we have to find some way to have a true insurance system. I mean, you know, if you're a guy driving an automobile and you have six accidents and your kids drive the other car and they have accidents as well, your risk is higher than a gentleman in some rural area that's been driving for years and never had one.

And I think that our problem here is that we don't have a contemplative deposit insurance system to deal with the different problem, altogether different financial institution and thrift situation that we've had in this country in the last decade or so compared to what we had in prior decades.

Now that may be an oversimplification, but I'd like to hear what you think of that.

Mr. SCOTT. Well, I think the thing that strains any financial intermediary system, and any insurance scheme that's backing it up, is instability, volatility.

If you're in a relatively stable period, there will be failures on almost a random, stochastic basis and they don't present much of a threat to the system or to anything else.

The problem comes when you, for whatever reason, get some kind of a large shock to the system—whether it's the oil crisis or recession in Third World countries, or whatever form, international or domestic, it may take.

When you get a large shock that creates instability in the system and that tends to produce a correlated wave of failures, that's when you test the system and that's when you test for its inherent strength. And that's when you test the insurance backup.

At some point, those shocks will come along from time-to-time. What you can ask of a deposit insurance system is that, at the very minimum, it not magnify the problem because of the way in which it distorts incentives and the way in which it is administered.

That I think is what we have been witnessing in the 1980's. The sources of the great S&L collapse were essentially to be found in 1979, 1980, 1981, when you had a huge inflation and double-digit mortgage rates, and so on, that just massively devaluated the portfolios and left the industry insolvent.

All right, at that point, what happens next?

What happened next was that an exogenous problem was made worse by the way the deposit insurance system and the regulatory system responded to it.

You can't always prevent the external shock. You can certainly try not to make it worse.

Senator **Dixon**. But, if I could interrupt at that point in time, I agree with everything you've said. But, now, at that point in time, we began to see that the system wouldn't work any more. And we see now the continuing evidence of it: thrifts out there paying over-the-market rates to keep floating along and increasing their risk, and everybody undertaking great risk to try to dramatically get back in a better financial position through luck, and the big gamble—and the system isn't going to work.

Now, if we don't repair the system, we're never going to get rid of the problem, I would submit. Maybe, I'm wrong. But, it looks to me like this thing will get worse and worse and worse and worse and worse until we do something to the core system.

I mean, I accept—you know, sometimes, you have to cut your losses. Now, what's occurred has occurred. Probably, we can't repair that any more. That's done. Everybody would have some disagreement about how well it's been repaired. That's a subject for further argument.

But, the question is:

How we do from this day forward something that gets this thing back in shape?

I just wonder what you think about that.

Mr. **Scott**. I'm in total agreement. And I think that, when you are concerned about changing behavior that is damaging, what you should look to are the incentives that are creating the behavior. And it's at that level that the problem should be thought about and addressed.

I agree completely.

The **Chairman**. Mr. Ely was going to make a comment.

Mr. **Ely**. The basic point is that this is an inherent problem in Federal deposit insurance. As I said earlier, governments cannot make deposit insurance programs work. The incentives just aren't right.

Effectively, we have to privatize the risk assessment process and, really, the risk-sharing. I would suggest to you that Federal deposit insurance made the S&L crisis a lot worse than it would otherwise have been and, in effect, exaggerated the exogenous shock problem.

Senator DIXON. I think that, too.

Mr. ELY. Look at what happened in Texas, for instance. The real estate construction boom that was fueled by S&L lending in Texas took off in about the second or third year of the energy decline. Lending should have been going down, not exploding.

My sense is that this landing boom would not have happened. under a sound deposit insurance system. In other words, Federal deposit insurance not only allowed the problem to develop in the first place, but then it magnified its consequences.

Again, I think Professor Scott has come up with a couple of excellent ways in which to judge reform proposals.

I would suggest to you that those criteria cannot be met by a Government deposit insurance scheme. And this, of course, is exactly what Franklin Roosevelt recognized, which is why he issued the warning he did in 1933 about the dangers of Government deposit insurance.

Mr. CONNELL. Senator, I'm not necessarily in favor of eliminating the Federal insurance, but I think you can do an awful lot to improve it. And it's not that difficult to put in a risk-based premium system.

And we have a lot of data now from these failures of the last 10 years to work on. But the CAMEL system is a beginning and it—well, people distrust it because of subjective aspects of it.

Private insurance has subjective aspects to it. So, what's important is you get the attention of directors when you put a cost on increased risk.

And they'll say to their management: No, you'd better clean that up. It's costing us X-million dollars a year extra because of whatever risk they're taking on.

Senator DIXON. That's right.

Mr CONNELL. I also believe that the use of subordinated debt of a different type that triggers defaults on capital ratios falling or delinquency ratios could provide even more private market discipline.

I've been watching chapter 11 proceedings and creditors taking over companies. They remove management and reorganize. And if that can be done at a quick enough level, the private sector can take care of this before you wipe out all the capital and have to have regulator action.

So I'm very much in favor of it. It's not that difficult to put in place.

Senator DIXON. I appreciate that.

The CHAIRMAN. Thank you, Senator Dixon.

Senator DIXON. I just want to thank the Chair for its usual kindness and consideration.

The CHAIRMAN. Well, those are important questions and I think they really help frame the discussion.

Senator Heinz, did you have an opening comment that you wanted to make?

Senator HEINZ. Mr. Chairman, I'll put it in the record. I don't want to prevent you from having your round of questioning. You've been most patient.

The CHAIRMAN. Well, thank you.

I want to raise a collateral issue with you because I value your experience, that I cited earlier with respect to what the pattern has been in commercial banking. We've got an extraordinary example in what we've seen in the savings and loan system.

When we developed the FIRREA legislation last year, one of the conclusions I drew, from the collapse of a large part of the savings and loan system, was that the issue of State powers was powerfully important.

We found, for example, in the last year for which we have full data that 70 percent of the Federal losses, the national losses, coast to coast in the savings and loan system, came from two States—Texas and California.

We went deeper. We found that, in those two States, the States had greatly expanded the power patterns beyond those allowed to a federally-chartered savings and loan.

In the area of junk bonds, for example, the Federal Charter allowed savings and loan to have up to 11 percent of its assets in junk bonds, but the State of California allowed one State-chartered thrift to have almost 34 percent of its assets in junk bonds.

Direct investment in real estate was another major factor. Some States stretched this power out well beyond what the Federal Charter allowed. And we also saw that pattern particularly in those two States.

When other problems arose, Mr. Connell, I am sure that you saw them in the southwest economy, particularly in Texas.

States had the authority to broaden the risk patterns that you, Mr. Scott, were speaking about. They could permit movement into areas that, in their view, were attractive expansions of business activity for a State-chartered institution.

Yet, all of that was connected directly back to Federal deposit insurance. The States themselves carried no deposit insurance risk for expansion of powers that they were authorizing. But the Federal taxpayer was being put right on the hook to back up any problems that arose.

And profound problems did arise in that area.

Now, the argument is made on the other side that you want diversity in the banking system. States permit commercial banks or savings and loans to innovate. We hear about the development of money market checking accounts and things of that kind. But it seems to me that anything that Federal deposit insurance will cover ought to be defined within a Federal Charter.

It seems to me that if we retain a deposit insurance system, however it may be changed, that we ought to define from A to Z what that deposit insurance covers. We ought not to allow other units of Government to take a free ride on Federal deposit insurance by deciding to allow whatever they want as add-on activities.

Would you agree with that, Mr. Connell? What would be your thought?

Mr. CONNELL. I guess I'll have to put my hat on as a State Regulator, which I was at one time, and say I do favor the dual chartering system because of the innovation.

And the first innovation I saw was actually on the Federal side under Comptroller Jim Saxon, when I worked for him as a young bank examiner.

Later on, that abated. And the innovations came at a State level. For instance, the NOW accounts in New England.

The problem that happened in Texas and California was a near abdication of responsibility by the State authorities, particularly of California at the time.

I've been actually looking to State law. Well, first, let me say the Federal insurance coverage is a Federal issue and certainly the Federal insurance agency should have veto power or some way to control the risk by State, by State-chartered institutions. They shouldn't have a free ride on the Federal system.

And so I agree with you on that concept very much.

What I'd like to—and I think it can be done that way, with either an extra premium or a veto power, if it's considered too risky.

I found some very helpful things in State law in reorganizing I think the new thrift industry. The Federal Thrift Charter—or Federal Savings and Loan Charter and, in many cases, the State Savings and Loan Charter did not have the prudential standards of conduct embedded in them that the Mutual Savings Bank Charters did in places like Connecticut, Pennsylvania, New Hampshire, Maine, Massachusetts, State of Washington.

And I think there's room now for the Congress to look at some of these State charters and the way they crafted the powers. And the powers of northeastern savings banks are very broad. But we haven't had the same type of problems that we had in the West. We're having a problem with real estate in general up there, but it's not distinguishing between types of institutions.

But, the savings bank charter came from the Eleemosynary Trust Concept and the trustees or directors had fiduciary duties. So you had very little, if any, insider dealings. It was a fiduciary history that took care of that.

As they implemented new powers, they did it gradually. Unfortunately, in California, it came in a big way—it just opened doors. So people didn't have time to make small mistakes, they had an opportunity to make big mistakes.

So I think there's a dynamism in the dual system that shouldn't be thrown out. And we ought to take the best of what exists at a State level and probably develop a Federal savings bank law somewhat similar to that to define the role of a thrift, because thrift doesn't say anything about housing finance.

It says just thrift. And it's been interpreted to be housing finance, and it really isn't when you go back to the history, the financial history of our country.

And I would urge that the committee explore the thrift institution from the perspective of the Northeastern Mutual Savings Bank and see what we can get good out of that.

The CHAIRMAN. Interesting idea.

Mr. Ely.

Mr. ELY. Well, I think the thrust of FIRREA was very sound because: He who takes the risk should regulate.

And so, since the Federal Treasury is bearing the risk of failure, the Federal Government has to be preeminent in banking regulation.

But, it is a good point that dual chartering has allowed innovation. I would suggest, however, that the best place for innovation to take place is in the marketplace.

That is where we look for innovation in other sectors of the economy. And the same is true here. Not only should innovation be taking place in the marketplace rather than in regulations and statutes, where it's hard to stay up with new innovations, but also the risk should reside in the marketplace. So we need a system that ends the cost to the taxpayer when some marketplace innovations do not work out.

The CHAIRMAN. Mr. Scott, do you have a point you wanted to make? Otherwise, I'm going to go——

Mr. SCOTT. Well, just one comment. And that is I think it's important to distinguish between the existence of powers and, again, the incentives that bear on the way powers are exercised. The crucial issue, it seems to me, in what happened in the 1980's was not so much the powers but the incentives.

Powers may be broad or narrow. You know, banks are relatively a broad franchise, savings and loans a rather narrow franchise. Strictly from the issue of powers by themselves, it seems to me there are very strong reasons to prefer a diversified portfolio.

The bulk of the institutions, banks as well as S&L's, that have failed have been small, locally concentrated, narrow spectrum institutions—woefully undiversified in their investment portfolios.

The crucial issue is, more than powers, it seems to me, the incentives for the management in the exercise of those powers. The problem that took place in Texas and California was that you had insolvent institutions with no money on the part of the owners left to lose that were being allowed to stay under private operation year after year.

And in that case, you're going to see extreme risk-taking. But, you can take extreme risks in real estate lending as well as in any other field. You can make huge interest rate bets by taking positions on long term fixed rate mortgages or mortgage-backed obligations.

So, the critical thing, it seems to me, is the decisionmaking incentives, when you want to understand a high rate of losses.

The CHAIRMAN. I'll just make one other point and then yield my time. When we began to consider this issue last year, we spent 17 days on hearings before receiving the administration's bill that became FIRREA. We wanted to lay out the breadth and dimension of what had taken place.

Brokered deposits became federally insured deposits because of the Federal deposit guarantee. With brokered deposits you had a situation develop where hot money, collected around the country, was shipped to institutions with Government insurance. These troubled institutions were offering above-market interest rates to attract that hot money.

In many of the cases, the people—the major companies—who were offering the hot money, also began to offer junk bonds, in the same transaction.

In other words, they'd say, look, interest rates are at 9 percent, but you'll pay us 10 percent. We'll give you a block of $100 million. And, by the way, we have $100 million worth of junk bonds to sell, that are yielding 14 percent.

If you will pay the premium on the deposit interest rate, we will give you another opportunity to clip off a 4 percentage point spread. And that accrues to you. Meanwhile, the Federal Government underwrote the whole transaction. And it began to mushroom.

This is just one piece of a much larger problem. It seems to me that if Federal deposit insurance allows such a mechanical set-aside of the risk assessment that you have got exactly the dynamics that will create the problem you don't want.

The system will exhaust itself in these weak areas if we allow it.

In any event, Senator Bryan has come in. Senator Gramm has come in. Before I call on Senator Heinz for questions, do you have any opening comment?

Senator BRYAN. No opening comment, Mr. Chairman.

Senator GRAMM. No opening comment.

The CHAIRMAN. Very good.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much.

I want to commend our witnesses and you, Mr. Chairman, on this hearing because I think it's one of the most interesting hearings that we've ever had; although I didn't hear the testimony of the first two witnesses and came in the middle of Professor Scott's testimony, I have read the testimony. I find it extremely useful and interesting.

I can't resist the observation that we in Washington, DC probably should be called to account under the Truth in Advertising law when we use the term "Federal Deposit Insurance Systems."

I say that because I don't know of any insurance system that would charge the same premium for all policyholders. Senator Dixon was talking about that.

I don't know of any insurance system that would place a limitation on coverage and then protect the insured and uninsured alike.

And I don't know of any other insurance system that would keep reserves at levels that bear absolutely no relationship to the actuarial losses and risks that exist.

I think what we probably should have called Federal deposit insurance is the Federal deposit credit card, because we've encouraged all these institutions to go on a whirlwind shopping spree. The result is that we're having the largest garage sale, particularly in the Southwest, in the history of this country.

I guess that's what you do when you end up with a garage full of junk. I'm not referring to high-yield securities, per se. Just junk, generally.

There is the view, and Senator Riegle was talking about this a moment ago, that much of the S&L crisis was caused by the expansion of permissible activities for thrifts, so-called deregulation. As Mr. Connell indicated, there was a vast regulatory failure.

But there's another view. One of the reasons that Congress made the decision to expand thrift activities was that, for so many years, the savings and loan institutions had been forced to invest too much in one particular kind of asset, namely, residential mortgages.

Having too great a concentration there, too little diversification elsewhere, that they were set up.

And my question is:

How much validity is there to the view that what happened after 1982 was really caused by what happened before 1982? Namely, the overly-excessive concentration, which I guess we have to take some responsibility for, for mandating the thrifts invest excessively in mortgages.

Mr. Scott, would you like to make a comment about that?

Mr. SCOTT. Well, that is an issue I try to address at some length in the longer paper that's submitted for the record.

It seems to me that what killed the savings and loan industry was high inflation. And what killed them, therefore, was the bad imbalance between asset and liability maturities. They were inherently subject to enormous interest rate risk.

And if interest rates were going to move up sharply at any period in time because of inflation, their asset portfolios and their operating earnings were going to plunge into the red.

And that's what happened in 1980 and 1981. And by the end of that period, as ex-Chairman Pratt has testified, essentially every institution in the savings and loan industry was insolvent.

So you come out of 1982 having totally devastated the entire industry. And the question is what's going to happen next?

And two things happened. Inflation came down, was brought down if you like to put it that way. Therefore, a lot of the asset values increased. And a fair portion of the industry was returned to solvency and when they are solvent, they have some of their own money on the line. And they have more reason to operate in a more prudent manner and not take risks without bound, and so on.

But, a large fraction of the industry was not restored to solvency. And that portion of the industry kept on operating. And that's the portion of the industry that you're paying for now.

So it's a twofold problem. One, there was the initial wipeout. And that's because the S&L industry is structurally flawed. It's an accident waiting to happen.

Senator HEINZ. On that point, and that really is why I asked the question, and I'd like each of our witnesses to comment on it, we have, under FIRREA, mandated that thrifts meet a QTL test where 70 percent of their investments must be in mortgages, in housing lending.

Are we, despite all the other improvements we made in the regulatory system and capital and so forth, setting the industry up for another fall? Or, are there reasons that we can breathe easier?

Mr. Scott, then Mr. Ely, and Mr. Connell.

Mr. SCOTT. Simply from the standpoint of the design of a financial intermediary, that's a step backwards. That's making them less diversified and more vulnerable.

Now, if you wanted to say it's their whole reason for being, that we are willing to incur all of this added risk and exposure to the insurance system because we think it produces benefits over here in the housing market that are worth the cost—and as we've just learned, the cost can be huge—you know, that's a dubious but separate issue.

Senator Heinz. So your view is that the 70 percent QTL imposes added risk on the insured system.

Mr. Ely, I see your head nodding. I don't know whether—I don't know what that meant.

Mr. Ely. I think that the QTL test does add risk. And I would hope that in the future the QTL test would be rolled back or done away with altogether.

I'd like to come back to your earlier comment about the S&L industry and, again, this is reinforcing what Professor Scott said. The S&L essentially was an institution doomed to fail because the traditional S&L was taking short-term deposits and making long-term fixed-rate mortgages.

The reason that the industry got into serious trouble between 1980 and 1982 was not so much that S&L's were concentrated in housing finance but that they had portfolios that were concentrated in fixed-rate mortgages.

Had S&L's been originating nothing but variable-rate mortgages, had we banned fixed-rate mortgages, we would not have seen the kinds of problems in the early 1980's that we did.

So it was not the concentration on home finance, but the S&L's emphasis on fixed-rate mortgages that caused the problem.

Coming back to the current situation, one of the things we have to remember is that housing finance itself has changed enormously in the last decade. The computer basically has unbundled the housing contract, the home mortgage, into three distinct pieces. We have got three different industries now; instead of an integrated housing finance producer, which the thrifts were, we now have the mortgage origination, servicing and funding industries. They are very different businesses.

I don't think public policy and I don't think housing finance needs to have any institution, such as the S&L, that is forced to channel a lot of its resources into home mortgage finance.

So what Congress tried to do with the QTL test is meet a need that no longer exists.

The problem with the QTL test is not only that some institutions may fail, but we have an even more widespread problem than that. What, we have today are lot of institutions that are meeting regulatory capital standards, they're succeeding from a regulatory perspective, but they're failing in the marketplace because they can't earn adequate profits.

And that is a slow spreading cancer that really concerns me. And it going to continue spreading until we get rid of the QTL test.

Senator Heinz. Mr. Connell, where do you come out on this?

Mr. Connell. I agree with both these gentlemen and I'll approach it from a little different standpoint.

You have the interest rate risk problem, the concentration problem and the narrowing spread problem as these are securitized.

And so, as Mr. Ely says, it's going to doom these institutions to disappear. Merger or failure, as only large ones remain.

Second, thrift does not mean home lending. In fact, in the history of mutual savings banks, there was a prohibition on having mortgage loans in excess of 50 percent of their asset base because it was imprudent. And, in fact, the current law reflects that by a concessionary PTL percentage for savings banks.

I think we have a restructured home finance support system now. We went part-way with FIRREA in admitting commercial banks and credit unions to the Federal Home Loan Financing System, but they were admitted on a prejudicial basis in terms of the formula for membership.

I think that needs to be changed. But the overwhelming change is that our home financing support system—it's a subsidy system—was based upon the deposit insurance of S&L's, the charters of S&L's, the tax advantage they used to have.

And that's all obsolete now. And I think that the subsidy of the future should be based on the savings function as opposed to the deposit function. And the qualified thrift lender test should be changed from a percentage of mortgages to a commercial bank test, where you——

Senator HEINZ. Say that again?

Mr. CONNELL. I think we have it just about backwards from the way it should be.

The definition of a thrift should not be how much it has in mortgages, but how much it has in unsecured or non-real estate-secured business loans, because then it becomes a commercial bank.

I think the test is just backwards. We should have a commercial test, not a thrift test.

Senator HEINZ. Mr. Chairman, my time has expired. I would like to, unless they are answered on the record by somebody else, submit two questions to the panel, one having to do with soliciting comment on Mr. Ely's comprehensive private cross-guarantee plan. I would like Mr. Scott and Mr. Connell to comment on that, if they are not asked to.

And second, I have a question on risk-based premiums, the substance of which is whether, if we did in fact have a risk-based system based on actuarial principles, would the cost of deposit insurance become prohibitively expensive?

I will submit those appropriately. Thank you, Mr. Chairman.

The CHAIRMAN. Very good. Thank you, Senator Heinz.

We will go to Senator Bryan, but first let me ask Senator Shelby, did you have an opening comment?

Senator SHELBY. Mr. Chairman, I have no opening statement.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

I was intrigued by the colloquy between the three of you and Senator Heinz with respect to the QTL test. There are a lot of us who see a part of the debacle occasioned by a far-ranging category of investments that were permitted when the laws were relaxed that were far beyond the capability of many, even those that were not affected by fraud or criminal misconduct. And as you know, there is a substantial percentage of those, as the evidence is beginning to come forth, but the dynamic of the regulatory function changed.

It seems to me it is a lot easier, if you are essentially in the home mortgage business, than if you are involved in a wide range of diversified interests which many of the S&L's got involved in, some of which without much prudence I would add. Would we have been in worse shape—and this is my question—would we have been in worse shape, in your view, if we simply had not changed the law at all in the early 1980's to permit that additional diversification?

I do not know how the numbers could get much larger, but perhaps you could share that with me.

Mr. Scott, I will toss the ball to you, and then ask Mr. Ely and Mr. Connell to respond.

Mr. SCOTT. That is a difficult question to be sure of. In many ways, Garn-St Germain it seems to me was the right step at the wrong time. But I am not sure how much—your question is really how much difference it made in the outcome, and I am not sure it made a lot of difference in the outcome.

If I try to find an analogy—you had an insolvent industry then, so you had many people who were opting for a gambler's strategy to try to earn their way out of the hole. And I guess my metaphor would be, if you want to play a high-risk strategy, you can play it in almost any field. So it is as if they had access to a roulette wheel. They can take gambles in real estate. They can play real estate roulette. You can make the long-term investments or buy the long-term securities and take an interest-rate plunge. You could engage in financing large-scale projects—that was within their traditional historical powers.

What the 1982 legislation might be seen as doing is saying: well, here are a few more games. You do not have to play real estate roulette; you can play blackjack. You can play Keno. We are making a wider variety of gambling strategies available to you.

The CHAIRMAN. A diversified casino.

Mr. SCOTT. A diversified casino. [Laughter.]

But the incentives were wrong, and they were taking high-rate/high-risk plunges. And a lot of those, by definition, are going to lose. So it was the fact that they had the incentives to go for the high-risk/high-odds/high payoff kind of investments that, it seems to me, is the driving force.

Maybe having more games at the casino made it somewhat easier for them to implement that strategy and somewhat harder for the supervisors to monitor. But supervisory monitoring was constrained by a lack of resources. They monitor. They find the institution is insolvent. What do they do about it? They cannot close it down. So the supervisory monitoring, even if made more difficult, was ineffectual at that point in time anyway.

Senator BRYAN. Do you not think some of it was attitudinal, though? I want to get Mr. Ely and Mr. Connell's comment to my basic question, but before that, Mr. Scott, do you not think some of it was attitudinal when you are in effect told that the joy of life is deregulation? That the ultimate end of all good policy is to do very little, and that ultimately the market forces will work out and come to benefit the public? Do you not think that had a bit to do?

Because my perception, and I was not at the Federal level, is that there was a protracted period of narcolepsy that most of the Federal regulators were involved in during that period of time, and I suspect that some of it reflected a philosophy or a prevailing point of view that swung rather far on the pendulum—at least from my own perspective, and now I think we are beginning to see that pendulum move more back to the center—but could I get your response to that? And then I will ask Mr. Ely and Mr. Connell to respond to both of those.

Mr. SCOTT. I think that is fair. I do not think that the supervisory response was as vigorous as it could have been, even given their limitations.

On the other hand, when you talk about working fundamental reform, keep in mind what the limitations on the supervisory process are and always will be. The examiners come in after the decisions have been made, after the investments or the loans have been put on the books. Now they can criticize, they can try to say do not do it again and so on, but essentially they are responding to water that has gone over the dam.

Where you really want to intervene in the process is at the point where decisions are occurring in the first instance. If those are warped and distorted by the deposit insurance system itself, then examination and supervision can run as hard as it will but it will never catch up.

Senator BRYAN. Mr. Ely.

Mr. ELY. Coming back to your original question, I think it is fairly easy in hindsight to say that we probably are worse off for the way the powers were used, but again I do not think that that is necessarily a condemnation of the powers that were granted.

What happened, particularly after 1982, is that there was an enormous breakdown in the regulatory process, in part because many insolvent institutions were allowed to continue in operation after they became insolvent. Whether these S&L's had been continuing to make traditional home mortgages or taking lots of speculative risks, they still were in trouble. The speculative risk-taking only made things worse.

If we look at the 1983, 1984, 1985 period, particularly, there was an incredible regulatory breakdown, of regulators just being totally blind to a lot of new risks that were taken on. It is interesting to look at the data, as I have for Texas, where we see a real estate lending explosion funded by Texas S&L's, starting in 1983, a couple of years into an energy decline in that State. There was absolutely no macro economic reason why that lending explosion should have taken place, and yet it did.

The regulatory process did not even see it happening. And even in situations where they seem to have had some awareness of it, the regulators did not act. So what happened is not necessarily a condemnation of the granting of the additional powers, but how they were used and how they were regulated.

Senator BRYAN. Mr. Connell.

Mr. CONNELL. Yes. In terms of the expanded powers, they were probably too much and not modulated in the implementation. The Northeast Savings Banks got commercial lending and other powers little by little each year as they fought in the legislature. So again the mistakes were small when they made them.

When credit unions got broadened operating powers, the Congress required implementing regulations to be written. This gave the agency the requirement to think out how these were to be done, and to put limitations on behavior to limit risk.

The two big areas of loss were construction lending and junk bonds. They did not lose a lot of money on consumer lending and that type of thing. Construction lending has always been one of the highest-risk forms of lending, and the commercial banking industry has suffered through cycles of losses on that for years.

The junk bond phenomenon was interesting because they were classified as commercial loans. I remember going into one association that had a large junk bond portfolio and I said to the credit person I brought in, I said, would you go up and look at that portfolio and classify it for me as if it were commercial loans? I wanted to get a feel of the quality of it.

He came back a couple of days later and he said: Mr. Connell, he said, the banks are all ahead of us. He said, those are not bank loans. I cannot classify them as bank loans. Those are equity-type investments. So the junk bond itself was not a commercial loan, unfortunately; it was a form of equity financing done in debt form for tax deduction purposes. And that was why the losses were so heavy there.

The third area of loss was just the general collapse in Texas. I saw apartment loans that were made in 1977, 25 percent down, perform for 10 years and go into foreclosure. On a massive basis they had more foreclosures in that period, in the 1980's, than they had in the 1930's. So you had a collapse of the economy in that State.

The CHAIRMAN. Even with a 25 percent down payment?

Mr. CONNELL. That is right, Mr. Chairman.

The CHAIRMAN. Would that not be quite high, traditionally?

Mr. CONNELL. The values deteriorated because of the crash of that economy down there. I am not talking about just one or two; I am talking about whole portfolios that were made prudently 10 years earlier, income property loans. These are participated out, by the way, to the northeast, to the midwest, to associations that had low loan demand, and they are beginning to take losses. You see it in the papers. Losses in Texas. Those loans were made in the 1970's, and they were made prudently, a lot of them.

The CHAIRMAN. Excuse me.

Senator BRYAN. Mr. Chairman, my time is up. Thank you.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I want to apologize to all three of you. I was not here. I was in another committee meeting, and you may have already answered these questions. They may have been asked, and I would not know it, so if they have just tell me and I will get that part of the record and save your time and the committee's time.

Mr. Scott, specifically you suggest that the FDIC charge risk-based premiums. What is the difference between risk-based insurance premiums and risk-based capital standards?

Mr. SCOTT. They have a lot of similarities. I think that the—I actually was not trying to urge either, or anything in particular as a solution. That was not the direction of my remarks. But if I address those issues, I think the problem with either risk-based insurance premiums or risk-based capital is: How do you assess the risk for the non-traded portion of the institution's asset portfolio?

If you do not have secondary trading markets, there is no objective way to do that. So it becomes a subjective assessment.

The theory as to how you would do it is perfectly clear and worked out in finance theory, but you do not have the data if you do not have a trading market. So I think it is extremely difficult for a Government agency as a monopoly provider of insurance, or as a monopoly setter of capital requirements, to get out of a risk-based approach the objectives that you would wish: that it will be really sensitive to variations from institution to institution. If you are going to achieve that, I think you have to either—well, you can either say, I will achieve it as best I can; I will price and I will assess those risks that I can measure; I will make a few guesses, if you like, about the rest; and I will go forward on that basis knowing that it is less than theoretically perfect.

Alternatively, you can try to arrive at a composite, subjective judgment by a number of participants in a competitive market, so that for example you can try to price Government deposit insurance off of having some portion of it being privately provided. And that of course essentially is Bert Ely's proposal through the form of a cross-guarantee insurance syndication market.

The issue that you have to face then is: What is the risk that the market is trying to assess? It is the risk that the institution will become insolvent during the period that the insurance is in force, and then the amount of the loss from that insolvency, times the probability that the institution will be closed by the regulators during my insurance period.

So any risk-based system that relies upon the supervisors' foreclosure is subject to a great deal of uncertainty as to whether they will act or whether they will not act in any period, even though the institution is economically insolvent. And if there is a probability that they do not act, although the institution is economically insolvent, then you are in effect under-assessing the risk.

Thus the thing that you have to look at in any scheme that is risk-based is: Who makes the subjective judgments? It is very difficult for a Government monopoly agency to do that except on a gross under-estimation basis, because that is the only way that is defensible under all circumstances. And if you are relying on private mechanisms to make the risk assessment, they in turn depend upon the closure regime that you are operating in. And the closure regime, as I was indicating in the earlier portion of my remarks, is another place where the deposit insurance system is at the moment extremely vulnerable. Closure is not prompt. It is delayed. Forebearance is the policy that constantly keeps getting resorted to.

Senator SHELBY. What level would you recommend lowering deposit insurance limits to?

Mr. SCOTT. I think that lowering deposit insurance limits has a marginally beneficial effect if—and only if—they are adhered to.

Senator SHELBY. Lowering them, themselves, will not matter that much?

Mr. SCOTT. You have a system right now that says the ceiling is $100,000, and you have institution after institution in which there are full payoffs. So, de jure, you say $100,000; but de facto, the regulators convert it into 100 percent coverage of all depositors and all other creditors.

Well, if they have the discretion to turn a limited system into a 100 percent coverage, into a full kind of bail-out of all creditor claims, then what is the market discipline? What is the benefit you have gotten from your insurance ceiling, whatever it is? None.

Senator **Shelby**. Mr. Ely, let me ask you this. You may have gone into it earlier. I want to commend you for all the things you have said before this committee. I remember about 3 years ago you said it was going to cost a tremendous amount of money, and even you were conservative in getting up to $80 to $100 billion, and people were trying to laugh you off this table, but I have to give you credit, you were a lot more right than they were.

On this today, as far as cross-guarantee syndicates, how would they work? Would there be requirements that provide for market or portfolio and geographic diversification there?

Mr. **Ely**. That is a very important issue, and it is one that I have addressed in detail in a full-length paper I have written.

Senator **Shelby**. It is also complicated, is it not?

Mr. **Ely**. Well, it is complicated——

Senator **Shelby**. As far as implementing it.

Mr. **Ely**. Well, not so much in implementing it, but in terms of how it would work on an ongoing basis. The key is to have risk-diversification in the syndicates. The way to achieve diversification is to require two things:

Number one, that any one syndicate of banks—say the syndicate that guarantees Citicorp, Morgan or Chase—have a minimum number of guarantors, each of whom can only take a small piece of the risk.

For example, I suggest that guaranteed banks with more than $40 billion in assets have at least 200 guarantors, each of whom can take no more than ½ of 1 percent of the guaranteed bank's insolvency risk.

Senator **Shelby**. Are you drawing on the Lloyd's situation there?

Mr. **Ely**. The cross-guarantee concept builds a lot on Lloyd's.

Senator **Shelby**. OK.

Mr. **Ely**. It is not based totally on Lloyd's, but it is based in part on Lloyd's. But the key is, if we require a large number of guarantors for the big banks, we are automatically going to get a very wide geographical spread of the risk.

The other side of this issue is that individual guarantors concentrate no more than a certain amount of their risk assuming capacity on any one bank. Guanators must not place all of their cross-guarantee capacity on just a few bets. The key is to work in diversification. From that, the cross-guarantee system will bring about effective portfolio diversification and geographical diversification.

Senator **Shelby**. In Europe, the financial system is in some ways subject to more regulation than we have, and yet basically when banks have failed others have gone in and picked them up. But what if someone did not pick it up? What then?

Mr. **Ely**. We actually have seen a couple of close calls in Europe. My sense—and this goes back to a point I made in my opening statement—is that in Europe and in Japan, there is a "too-big-to-fail" policy, particularly after the Herstatt failure in Germany in 1974, which rattled the European regulators because of some of the large depositor losses in that bank. Despite whatever the de jure deposit insurance and supervision systems may be, if a big institution in Europe gets into trouble, the national government involved, through the central bank, is going to fully protect depositors and other creditors.

There was an interesting article in The Wall Street Journal this morning about Pan European banking mergers that are going to be occurring in the 1990's. Those mergers are going to put an increasing burden on the nation-states in Europe as to how they are going to deal with future bank failures where the bank is operating in two or three or many jurisdictions.

My basic sense is that European governments—in part, because they do not have this thing we call deposit insurance, are going to continue to ride to the rescue of jailing banks for some time to come, unless they end up with something like the American thrift crisis.

Senator SHELBY. Mr. Chairman, can I add just one comment?

The CHAIRMAN. Yes. Please.

Senator SHELBY. How would you deal with the requirement of cross-guarantee—in other words, that the banks guarantee of each other's risk of failure? By legislation? Would that be mandated as part of an overall banking law?

Mr. ELY. It would have to be an overall—it would have to be a piece of legislation that has what I call an "opt-in" provision in it that in effect allows individual banking organizations that can get the cross-guarantee coverage to effectively opt out of Federal deposit insurance and opt into the cross-guarantee concept, and at the same time opt out of a lot of the existing Government safety and soundness regulations.

What in effect would happen is the regulation of banking activity would shift more to the pricing formula for risk-sensitive premiums, and in a sense into the cross-guarantee contract. An insurance contract has a lot of regulation in it. We do not call it that, but it has the same thrust. So the idea is that you shift both the risk——

Senator SHELBY. But the premiums basically should be based on risk, should they not?

Mr. ELY. That is correct. The premiums will be risk-based premiums.

But the key thing is that risk-based premiums will be established in a private marketplace. In that way, the marketplace will deal with a lot of the concerns that Professor Scott has raised about a monopolistic Government agency assessing risk. Let the marketplace set the risk-sensitive premium rate and keep the risk.

Senator SHELBY. Mr. Chairman, thank you for your indulgence.

The CHAIRMAN. Those were very good questions.

Let me ask you, if I may, two "yes" or "no" questions.

The commercial banks are seeking broader powers. That is one of the issues that we are looking at in our hearings. Do you feel that we could afford to give broader powers without first, or at the same time, reforming the deposit insurance system? Do these things have to be cross-connected? Or could we go ahead and grant new powers and leave the deposit insurance issue to another time?

Mr. Connell?

Mr. CONNELL. The answer is, yes, that you could grant broader powers, and particularly those that are being considered, and leave the——

The CHAIRMAN. Safely, in your view?

Mr. CONNELL. Yes, safely.

The **Chairman**. Mr. Scott?

Mr. **Scott**. If you take the risk subsidy and the other problems out of deposit insurance, then I feel a lot more comfortable with the question. Otherwise, it seems to me an expansion of bank powers inevitably has to carry with it provisions to prevent there being an extension of the risk subsidy, which means you get into all the firewall issues.

The **Chairman**. Well, do I take it then that you feel they should move in tandem?

Mr. **Scott**. That would be ideal. If they moved separately, and if powers moved first, then it seems to me you have to take the firewall issue quite seriously.

The **Chairman**. Mr. Ely?

Mr. **Ely**. Politically I think they have to move in tandem, but more importantly deposit insurance in its own right needs to be reformed. We have to move on that, which opens the door to dealing with the powers' issues.

The **Chairman**. Now put the question a little differently. Let us assume hypothetically that new powers were not granted. Separately and apart from that, is it your sense that the deposit insurance system needs to be reformed even if we stay with the current system?

Mr. Connell, what is your thought on that?

Mr. **Connell**. Yes, I believe we need——

The **Chairman**. Even with the current powers, deposit insurance has to be changed, in your view?

Mr. **Connell**. That is correct.

The **Chairman**. Mr. Scott?

Mr. **Scott**. Yes. Absolutely. It magnifies the shocks all along, and when you get a great shock, you will get a great and expensive magnification.

The **Chairman**. Mr. Ely?

Mr. **Ely**. I think deposit insurance needs to be reformed as quickly as possible.

The **Chairman**. I appreciate that.

Let me move to a different area. I think we have had a useful overview of what happened over the last decade in the savings and loan situation. In 1980 the interest rate mismatch problem that developed tracked most of the S&L's offbase because of their long-term low fixed rate mortgages. Then new powers come along.

You have all conceded there was a regulatory breakdown during the 1980's. We had a lot of forebearance, a lot of forebearance arrangements, a lot of creative accounting designed to foster a workout arrangement. That was really the prevailing philosophy at that time.

Then we had State powers' expansion. We have talked about that today. Then we had a major regional economic downturn in the southwest. That really weakened a major part of the industry in that area that had previously been very robust. And we certainly had fraud and insider dealing woven through all of this.

It seems to me that the general philosophy was, as the problems began to emerge in a severe form in the early 1980's, that each time we should try to find a workout strategy to keep thing going and not stop and face the music.

The intention was different in the package that the Bush administration presented us last spring and which we enacted pretty much as they asked. We added a few things to toughened it up. But the administration said, "we are not going to try the work-out strategy anymore. It is time to face the music, fundamentally revise the industry, and go with real capital standards for S&L's equivalent to those for banks."

We chopped off the junk bond powers, which national banks did not have. We put a very severe limitation on State powers, and did a host of other things that changed the whole regulatory structure.

Mr. Ely, you correctly forecast years ago that the cost to sort out these problems would be a very big number, one which keeps enlarging with each new estimate. The RTC is in here on May 23, next week, and we will hear from them what their latest estimates are.

So we now have a chance to compare the two alternative treatments. The first treatment in the 1980's used a succession of strategies to work this thing out without having to go through the wringer in any severe industry-wide way. Now, we are trying the other strategy that recognizes the work-out strategies did not get the job done. Now there is a real reform package that is fundamentally revising everything. All of the old bad practices are being stopped.

We are going to honest accounting; real capital; and new constraints. We adopted a Bush administration recommendation contained in Treasury Secretary Brady's initial presentation to us of that package. They saw at that time that there was a justification for keeping a specialized home-lending industry, and their conclusion was very explicit and very clearly stated. I do not know if they still hold this view today, but it was their stated view then, and we incorporated that concept in the package.

Now we are are going to try it the other way. So we are setting up some big auctions to have, as Senator Heinz puts it, one of the great garage sales of all time to try to move a lot of these properties that we have taken back.

All three of you bring different perspectives to this issue. Though different all are highly valuable professional insights. Mr. Connell, you have worked through four of these failed thrifts, so you have an insider's grasp that is most helpful here.

We are ringing down the curtain on the multiplicity of strategies used through the 1980's. We are wringing this problem out and at its full cost. Are you convinced in your own mind that that is the proper course of action? While you might make changes at the margin, do you agree that we finally reached a point where the alternative strategy, the wrenching adjustment and cleaning out of all the excesses at once, is the right strategy?

Mr. CONNELL. Well, I believe the requirement for real capital and honest accounting is long overdue. I think we have given them an enormous burden, and the large numbers that are coming down the pipeline now over this next couple of years are going to be just a huge task of potentially creating an institution 50 percent bigger than our biggest bank in the country.

I think more can be done in the next couple of years in working these things through as going concerns, but not risk-taking concerns. And liquidating, the closer to a going concern can get, sometimes gives a better return on the assets. What is going to govern the disposal of assets to me is really going to be the cost to carry versus the potential value of the property, which indicates that an awful lot of this stuff is going to be sold earlier than later.

I mentioned in my remarks the creation of a chapter 11 type process with an administrative article III type judge system. I think concepts like that are going to have to be explored as we reach the next several levels of institutions that will not be able to recapitalize in the years ahead, maybe looking at some of the experiences of the depression and the RTC and that type of thing.

So I think more is going to be done, and these gentlemen have an enormous task ahead of them. I think we have to be patient and work and be flexible and open to new ideas as we go through this very expensive and painful process.

The CHAIRMAN. Mr. Ely?

Mr. ELY. I strongly endorse the cleanup process that was launched by FIRREA compared to the workout process of the 1980's. My concern today, though, is that the cleanup process may falter. It may falter because not enough cash will be provided on a continuing basis to keep the cleanup process going until we get to the end of it.

As in all economic matters, cash-flow is the ultimate economic truth. The cleanup process is cash-flow intensive up front. The administration, through the Oversight Board, was very wise last month to announce the significant speedup in the sale of the banking segment of these S&L's and to provide up to $51 billion for money to fund the speedup.

I am concerned because it is possible, as part of the budget reconciliation process for fiscal year 1991, that not enough cash will be provided to keep the cleanup going past the first couple of hundred S&L's that are now targeted for sale.

I also am concerned, if the speedup continues, that even by the fourth quarter of this year, the RTC may start bumping up against its borrowing limit under FIRREA. We could get into a situation where everything is going fine, everybody agrees the RTC is doing the right thing, but suddenly the RTC cannot borrow any more money under its FIRREA limits. I would hope, if it is possible, that the budget reconciliation process this year will not only keep the cash flowing, but make sure that the RTC does not bump into its borrowing ceiling.

The CHAIRMAN. We intend to question closely on that next week.

Yes, Mr. Scott, did you want to add anything on that?

Mr. SCOTT. Well, it is always disappointing for an academic to find himself in agreement with his colleagues. I would just come back to what for me is the bedrock, which is incentives.

You are going to have this enormous portfolio of properties, and you are going to have decisions that must be taken with respect to those properties: Do I sell them now? Do I sell them later? Do I put more money into them? Do I just cut loose?

You want those decisions taken by people who have their own money at risk, and that means that you have got to privatize those properties and those decisions as rapidly as possible. And that seems now to be what RTC has embarked upon, and that is I think clearly in the interest of the taxpayers.

The CHAIRMAN. I would be interested, in hearing your views on a couple of other questions on which we have a major oversight hearing up next week.

I would like each of you to comment on how you think the RTC process is working in the overall, and give any pointed observations you have to make about it.

Mr. Connell, let me start with you.

Mr. CONNELL. As I said earlier, the task of building an institution that is 50 percent bigger than our bank is enormous. I think it is still too early to make a judgment on it. I think on the positive side the use of the Federal financing bank as a financing tool, the cheapest source of finance was a very major and good decision.

I worry about this huge management portfolio that they have to take on around this country, these thousands and thousands of properties. I just think they face an enormous task in that area.

In terms of disposing of the banking assets, my concern is: Are there enough banks with capital to take them on? This will all sort out in the months ahead as they go through the process of analyzing what they have and then dealing with it. It is an enormous job, and I think it is really too early to tell yet. It has been a relatively short period of time for an enormous task.

The CHAIRMAN. Mr. Ely?

Mr. ELY. I think that as we judge the performance of the RTC, we have to realize that it is trying to function within the context of a highly convoluted organizational structure that is badly flawed. There are just too many parties involved and too many different interests that can bog the process down.

But even so, I have been disappointed in how the RTC has started up. While it is to be commended for speeding up the sale of the banking segment of insolvent S&L's, the deposits and the clean assets—even there I am hearing complaints that the RTC is not moving quickly enough in selling off a lot of its readily marketable assets.

But I think more specifically and more basically with regard to the problem assets, while it is good that the RTC has moved recently to cut prices, to move the merchandise, if you will, there still is not enough of an emphasis on the bulk selling of the problem assets.

My rough estimate, based on RTC data, is that the RTC might have to dispose of as many as 300,000 different assets that are of a troubled nature, and possibly more than that. That cannot be done in a timely way on a one-by-one basis. As I see it, the RTC is still trying to sell things on a one-by-one basis, which is very time-consuming and also very expensive from a transaction-cost standpoint.

The RTC will have to complement one-by-one selling with intelligent bulk selling so as to bring in bigger players, bigger sources of money, and bigger pools of talent who to a great extent are on the outside of this process looking in and not yet seeing how they can participate in privatizing the ownership of these assets.

The CHAIRMAN. Mr. Scott, did you have an observation?

Mr. SCOTT. I think the core of their problem is indeed the problem assets. The concern I would have over the way they are structuring their approach, now that they seem to be getting up to full speed, is that there is a preference, because it is obviously much easier, to do clean bank deals, or to do whole-bank deals with a year to put back assets on the RTC. Neither of those dispose of the problem assets which are where the problem is genuinely severe.

I would have the question—I am not close enough to the situation to know—I would have the question as to whether their preference for structuring arrangements that essentially leave them with the problem assets for yet another year or two in many instances is engendered by a concern about the sufficiency of working capital. Because if they do dispose of those assets, they are going to take ferocious haircuts on those assets, and there may be a kind of reluctance to fully face up to that.

The CHAIRMAN. Where you are seated today Robert Glauber was seated earlier this week. Robert Glauber is the Under Secretary over at the Treasury Department and one of the chief architects, maybe the chief architect in drafting the FIRREA package that the administration sent to us. Some people have suggested that the bill ought to be opened up this year to make changes of one sort or another. I asked him that question. I said: Do you think the bill ought to be opened up this year? And his answer was: We would prefer to see it work for awhile before it is reopened. Then I asked this question: Then the administration has no specific recommendation with respect to changes in the package? And he said: At this time, that is correct. And we went on in that vein.

Do any of you feel that there is a pressing need to go in and open that package up now to try to make significant changes in it?

Mr. Connell?

Mr. CONNELL. The two changes I would recommend would be changing the qualified thrift lender test to one of commercial bank test. I think it is just a concept that will do more harm than good right now.

And the second is to open the Federal home loan financing system more to commercial banks and credit unions so that they do not have the prejudicial formula.

I think those two are relatively simple things to do and would help both housing finance and the safe operation of the thrifts.

The CHAIRMAN. If you opened the FIRREA legislation up for awhile to do those two nice little surgical items, do you think that folks would be in here wanting to change. Other things in the name of forebearance, or workout, or lower cost, or whatever else? Would you have some concern that if you opened it up to do one or two little orderly things that you might have——

Mr. CONNELL. Yes. The answer, in a word, is "yes."

The CHAIRMAN. But are you inclined to think that those items are so important you would take the risk of reopening the package now? Or should we give the package a period of time to work?

Mr. CONNELL. I think those can be reopened now and they really do not relate to that huge job of the disposition of assets.

The CHAIRMAN. Mr. Scott, what is your view?

Mr. SCOTT. I agree that the whole issue undoubtedly is going to be revisited because of what FIRREA did not address, as well as some of the provisions it did contain, but I would disagree with Larry. It seems to me that in terms of making an assessment about that whole FIRREA package, it is early and it is not the best time to put everything back on the table for a reshuffle.

The CHAIRMAN. Mr. Ely?

Mr. ELY. Reopening FIRREA this year would be like standing 3 feet away from a hornet's nest when you hit it with a stick. So I think there is great risk if FIRREA is opened up.

If anything is done this year, it should be done at the initiation of the administration, with the President putting his leadership behind it and saying: We will propose a bill to address certain issues, and we will veto that bill if it becomes a Christmas tree.

With that said, there are some serious problems with FIRREA. I will just touch on a few. One is the QTL test. The QTL test should be repealed because the banking and thrift industries are coming together. The loan-to-one-borrower restrictions, of course, you have heard a lot about.

Something that concerns me very much that I touched on a few minutes ago is the ceiling on the RTC's borrowings. I am very concerned that the RTC will run out of borrowing capacity before this year is out. If there is any one reason to open up FIRREA, it is for that reason alone, but perhaps that can be dealt with in the context of the 1991 budget reconciliation.

The CHAIRMAN. I would think it could. On the financing issue many of us—you were one, I was another, and there were others on this committee—had great reservation as to whether the numbers were accurate. We thought they were low at the time, and said so a number of times. I think we could handle the financing issue separately and apart from substantive changes in the bill itself. We often do that, and I would think we could here.

But anyway, you were going to make another point.

Mr. ELY. Well, there is one other feature of FIRREA that should be repealed: The restrictions on banks buying S&L's. One of the most positive features of FIRREA—and Congress deserves the credit for this provision—is reversing public policy with regard to banks buying S&L's.

The two industries are coming together. We need to encourage the marketplace's melding of them by removing the remaining restrictions in FIRREA on banks and bank holding companies buying S&L's, and the reverse. And that brings us to exit and entrance fees, which also should be repealed. Those would be things that would be on my wish list for this year.

The CHAIRMAN. Let me ask you about a different area altogether. Is there a serious credit crunch out there that you see and that should be a matter of great concern to us?

Mr. Connell, what is your view? While you are down there in the Texas area, you think nationwide. What is your view?

Mr. CONNELL. There is an absence, or a lessening of credit available particularly in the real estate area. There is also an adjustment process going on. I heard one developer saying it has gotten really tight. We have to put our own money in now——

[Laughter.]

Mr. CONNELL [continuing]. And that is long overdue. That has been long overdue. The OCC and other agencies that have required more sensible financing are doing the right thing. The examiners are requiring these banks to do what they should have done all along. So much of this is an appropriate adjustment.

The CHAIRMAN. Is an "appropriate" adjustment?

Mr. CONNELL. Yes. It is quite appropriate.

The CHAIRMAN. In your view.

Mr. CONNELL. Yes. And the fallout from some of that is the implementation. And as you get down to the lower levels in a large financial institution, when the Board says it is time to limit our risk in real estate, there is a coaming out process and the smaller borrowers are usually the sufferers, whether they be small business institutions or small developers.

The other aspect is the loans to one borrower issue on small S&L's that made a specialty of betting the bank on one borrower. That too is a painful but appropriate change. I do not think the loans to one borrower provision should be changed at all. It was the appropriate response. We are going through the adjustment period now, and it is a part of the pain of it.

The CHAIRMAN. Is it your view that there is a credit crunch that's occurring from multiple, causes and sources and that is causing a risk to the economy? Do you see the so-called credit crunch putting the economy in a position of real risk at this point?

Mr. CONNELL. Not at this point. I think what we are doing is working off excess inventories in most places. In maybe 6 months or a year down the road it might become more serious, but we have a lot of over-building in a lot of places in this country, and it is an appropriate adjustment to have less of it.

The CHAIRMAN. Mr. Scott, what is your view? Do you have a view on that?

Mr. SCOTT. I think I would endorse what Larry is saying. If by "credit crunch" one means that there are certain types of loans in certain portions of the country that are being cut back, well, God save us all if that were not happening in Texas, and New England, and California, in the real estate field.

The only real meaning I think that "credit crunch" should have of any concern whatever is in a macro sense for the economy as a whole. It seems to me the evidence for that is lacking.

The CHAIRMAN. Mr. Ely?

Mr. ELY. I would agree with Professor Scott. The data do not suggest that there is a massive credit crunch, but a lot of people who are seeing it as a credit crunch may be seeing the pendulum swinging back with regard to credit quality. A lot of marginal credit is being cut back, possibly to some extent as an over-reaction to all of the published comments. But particularly in income-producing real estate, in many areas of the country, we are way overdue for a cutting back. A lot of real estate developers are having a hard time accepting it.

I would like to clarify one thing with regard to your earlier question about changes in FIRREA. I talked about the loan-to-one-borrower restrictions. I do not favor a permanent loosening up on that restriction for thrifts. Rather, I think FIRREA should have had a 2-year transition rule. If something were done this year, perhaps that could be put in. Since FIRREA probably will not be reopened until next year, by then we will be past the transition period. Therefore, I would agree with Mr. Connell's comment that we ought to leave it alone at that point.

The CHAIRMAN. Well, let me give you another piece of information on the loan-to-one-borrower issue since it has come up. I asked

Mr. Glauber about that very specifically earlier in the week. I asked him whether he thought something needed to be done on this issue, and whether the administration would be prepared to recommend something, if anything, that they might modify in the package.

This was his answer. We have received statements and visits from a number of institutions and groups who suggested that there are problems. I think in part, the problem is that there is no effective delay or transition date for those rules. It is our view and the view of OTS that there needs to be considerable transition flexibility for awhile. I do not think that has been understood by all of the participants. OTS is working hard to make it clear that this transition authority does exist and it is exploring further additional transition authority needs to be developed. At this point, we feel comfortable with the provisions as they exist. OTS is working to make them better, and I think we ought to see whether they can do that rather than a legislative reopening.

I thought that was a very interesting and quite specific comment coming from him. It put the administration clearly on record as to their view on this matter. They are asking how they might, within the present legislation, construct a transition that would keep faith with the intention of not betting the institution on a single lender or borrower, while still premitting more diversification and greater soundness in these loans.

So I wanted to share that approach with you.

We have had good participation by Senators and we have covered a lot of ground. Your full statements are very helpful to us, but is there any closing comment that anyone wishes to make?

Mr. Scott?

Mr. SCOTT. Just in response to what you were saying about the loan-to-one-borrower. It seems to me that regulation is kind of an awkward proxy for a problem that is acute really with regard to institutions that are insolvent, or near-insolvent.

The concern then is that you have the owners engaged in kind of a cozy circle of transactions with a few close associates, whether or not they are technically and formally affiliates, and it is part of a sort of final-period gambling strategy.

If the institution is adequately capitalized, I think it itself has every reason to take care of and be concerned about excessive loans to a single borrower. So the loan-to-one-borrower problem is very closely related to the problem of keeping institutions in operation with inadequate capital.

The CHAIRMAN. Yes, Mr. Connell.

Mr. CONNELL. Mr. Chairman, with respect to the loans-to-one-borrower statement of Under Secretary Glauber, he is accurate. The rule that is being proposed by OTS is a workable rule. It allows for transition in a prudent fashion requiring a continuing decrease of risk over a period of time, and I am working with it and I'm quite familiar with it. So it is going to be effective and I think do what needs to be done in a prudent fashion.

The CHAIRMAN. Mr. Ely is brightening over here because I think he just got a piece of new information from you, but I am not sure. Mr. Ely?

Mr. Ely. Well, to change the subject slightly and to return to the original or basic purpose of this hearing on deposit insurance reform, I hope that the committee will stay with this issue throughout the year, because it is quite possible that the administration, when it comes out with the Treasury Department desposit insurance study in November, could have some very far-reaching proposals to make in it. I do not think that the administration knows yet where it is going with this study, but I think 1991 could be a very dramatic year in terms of the changes that the Congress will have a chance to at least consider.

The Chairman. Well, let me conclude on that note by saying that is my view, as well. ~~We have~~ got a lot of things that are in a state of flux. We have become part of a global economy. There has been a set of major changes within the U.S. financial system. We have talked only about some of them today.

I gather that the administration is developing proposals that go far beyond deposit insurance to restructuring. I assume we will see them sometime early next year, if not late this year. So the committee has embarked on a series of advance hearings to grapple with this issue and come to understand it so that we will be in a position to know what we think and take it up and deal with it speedily, when the time comes.

We did the same thing on the S&L package. We had 17 days of hearings to clear the decks before the administration sent their package up here. So that the committee was fully emersed and ready to go by the time the package got here. That is why we turned it around in record ~~time.~~

So it is the intention of this committee to get this debate developed and understood. You have contributed each importantly to that objective today. We ought to be in a position to take the restructuring issue on and do it right.

Reform and restructuring will be done, one way or the other. Either the market is going to do it, or the courts are going to do it, or the regulatory people are going to do it, or the international marketplace is going to do it. And I would like to see us make some rational, sensible judgments and do it right.

That is our purpose, in which today's hearing plays a part.

Thank you, very much. We appreciate your testimony. The committee stands in recess.

[Whereupon, at 11:55 a.m., the committee was recessed, subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

LAWRENCE CONNELL

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Southmark Corporation

June 7, 1990

Mr. Donald W. Riegle, Jr.
Chairman
United States Senate
Committee on Banking, Housing, and Urban Affairs
Washington, D. C. 20510-6075

Dear Mr. Riegle:

This is in response to your letter of May 21, 1990 concerning my testimony before the Committee on May 17, 1990.

Questions from Senator John Heinz

Q.1 Bert Ely has proposed a comprehensive private cross-guarantee plan designed, in large part, to replace the current federal deposit insurance system. The foundation of this proposal rests on risk-based premiums, market discipline and a private industry safety net.

Will Mr. Ely's plan work? If not, why not?

Mr. Ely's proposal on cross-guarantee insurance has much merit. It is a scheme already employed in a number of states with regard to life and casualty insurance. Indeed, the private deposit insurance funds still in existence have a similar approach. Also, public deposit protection funds in many states employ the concept with respect to the collateral pools backing such public deposits. The state of Washington is an example. The cross-guarantee system would be as strong as the industry that backed it. However, that alone would not have been sufficient to prevent the public cost of the savings and loan industry collapse. I believe Mr. Ely's proposal would have special merit for excess deposit insurance, the amount above the federal limit and should be explored further.

Q.2. Your testimony suggests that risk-based insurance premiums are essential to eliminate incentives by management to engage in greater risks without incurring the costs of higher premiums. This approach would move deposit insurance towards an actuarially based insurance system.

If the deposit insurance premiums were based on sound actuarial principles, would the cost of deposit insurance become prohibitively expensive?

Do any other major industrialized countries have an actuarially base deposit insurance system?

I do not believe that the cost of deposit insurance, if based upon sound actuarial principles, need be prohibitively expensive. The cost of such insurance would be based upon the loss experience. As long as either a government or private supervisory system is effective, costs should not be prohibitive. The premiums on federal deposit insurance have not kept pace with the gradually increasing cost of the FDIC fund losses. Had the FDIC possessed sufficient flexibility to adjust premiums gradually over the past few years, the fund would not be as weak as it is today. Moreover, gradually increasing premiums would have encouraged bank managers to discipline the industry earlier,as the ultimate costs of risk taking would have been apparent earlier. I do not know of any industralized countries that have actuarially based deposit insurance systems.

I hope this is responsive to your request. Should you have any further questions, I would be pleased to respond.

Sincerely,

Lawrence Connell

LC:amv

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

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Financial Institutions Consulting

Deposit Insurance and
Banking Structure Studies
Public Policy Analyses
Strategic Planning

July 17, 1990

Responses to Senator Heinz's Questions Regarding Deposit Insurance Reform

Q.1. If deposit insurance premiums were based on sound actuarial principles, would the cost of deposit insurance become prohibitively expensive?

A.1. No, deposit insurance would actually be much cheaper for well-run, properly capitalized banks. Risk-based premiums most likely would range from 4 basis points for the strongest banks (one basis point = .01%) to 80 basis points for the weakest banks. For most banks, their risk-sensitive premium rate will be noticeably less than the 15 basis points which FIRREA mandates that they pay next year. Those banks paying higher premium rates finally will be charged for the risks they are assuming. Risk-based premiums will eliminate most of the $3-4 billion cross-subsidy which will flow from the good banks to the bad in 1991. Those banks for whom deposit insurance would be prohibitively expensive are banks which should not be in operation in the first place. These institutions will gradually disappear from the system, making the banking industry stronger, more efficient, and more competitive.

Q.2. Do any other major industrialized countries have an actuarially based deposit insurance system?

A.1. No other industrialized nation has a deposit insurance system where premium rates are calculated based on a bank-by-bank basis. It might be argued by some that risk-based premiums exist in countries such as France, Germany, and the United Kingdom where insolvency losses are allocated to the surviving banks after a loss has actually occurred. However, these loss assessments bear no relationship to the soundness or management of the surviving banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

KENNETH SCOTT

Q.1. Bert Ely has proposed a comprehensive private cross-guarantee plan designed, in large part, to replace the current federal deposit insurance system. The foundation of this proposal rests on risk-based premiums, market discipline and a private industry safety net.

Will Mr. Ely's plan work? If not, why not?

Having not made a sufficiently careful and detailed study of the Ely plan, I do not believe I am in a position to express a conclusion on it. But let me offer some observations on the plan, as best I understand it, on the levels of both concept and implementation.

Ely's plan should be seen as an effort to create a deposit insurance system that relies on the consensus judgment of private competitive markets to assess risk, set premiums and remove subsidies. It is clear that it is highly desirable to achieve those goals.

There are, however, some points that deserve careful attention. Ely's cross-guarantee syndicates rest of necessity on the capital base of the banking system as a whole--and for the system as a whole, bank capital (without government guarantees) is definitely inadequate. In the pre-deposit-insurance period, bank capital ratios were twice or more what they now are. To obtain a strong private insurance system, it would be necessary to bring more capital into the system. Ely does suggest reintroducing FDIC into the picture as a final backup insurer, but the danger is that would result in reintroducing the subsidy aspect as well.

Ely would also rely on the private bank underwriting syndicates to make the closure decisions, in an institutional setting that is not altogether clear to me. What would be the relationship between existing law (under which the primary supervisor is the only one who can put a bank into receivership or conservatorship) and the powers of the cross-guarantee syndicates? What set of contractual provisions in the cross-guarantee agreements is contemplated?

It should be noted that once reliance is placed on the terms of private contracts, disputes over interpretation or breach are the province of courts, which are needed for enforcement actions. There has been very little effective judicial review of governmental supervisory closure decisions, but one should expect a greater willingness on the part of judges to scrutinize the operation of private arrangements. The prospect of delay in closure reappears, though from a different source; there would have to be attention to ways to minimize the probable consequences.

Instituting the Ely plan also raises some questions. He would, I believe, make the new scheme voluntary. What that means is that no institution currently receiving a subsidy through under-priced federal deposit insurance would wish to give it up, now or in the future. It is not clear to me how a voluntary plan would operate in precisely the area where it is needed most.

Q.2. Your testimony suggests that risk-based insurance premiums are essential to eliminate incentives by management to engage in greater risks without incurring the costs of higher premiums. This approach would move deposit insurance towards an actuarially based insurance system.

If the deposit insurance premiums were based on sound actuarial principles, would the cost of deposit insurance become prohibitively expensive?

Do any other major industrialized countries have an actuarially based deposit insurance system?

- I do not have the data from which to calculate the cost of an actuarially sound risk-based deposit insurance system, and I do not believe that any other country has attempted to institute such a system, thereby providing us with at least comparative data.

The inquiry is not wholly without guidance, however. There is a market for major bank CDs, in amounts which exceed the deposit insurance ceiling, and it may provide some sense of the risk premiums that a market system would charge. In 1986, I collected data on large ($1 million) bank CDs, and found a range in rates of about 230 basis points. (See Scott, "Deposit Insurance and Bank Regulation," 44 Bus. Law. 907, 916 (1989).) For a number of reasons, the spread in a system of properly priced risk-based insurance premiums would be substantially greater.

Riskier banks would undoubtedly claim the cost was "prohibitively" expensive, but the claim would actually be a demonstration of how much a subsidy they were currently receiving from the taxpayer. For banks which chose to operate at the low-risk end of the spectrum, deposit insurance rates might well come down from the present level.

MAKING DEPOSIT INSURANCE SAFE THROUGH 100% CROSS-GUARANTEES

by Bert Ely

This paper has been produced in part under a grant from the National Chamber Foundation, an affiliate of the U.S. Chamber of Commerce. The 100% cross-guarantee proposal outlined in this paper has not been officially adopted by the Foundation or the Chamber of Commerce.

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MAKING DEPOSIT INSURANCE SAFE THROUGH 100% CROSS-GUARANTEES

Executive Summary

Deposit insurance badly needs to be reformed. Unfortunately, federal deposit insurance cannot be fixed because it is inherently flawed. Deposit insurance can be reformed only by completely replacing federal deposit insurance with a sound, private sector insurance mechanism. The 100% cross-guarantee concept is that mechanism; further, it is the only comprehensive and feasible reform proposal that has been offered in the growing debate over the future of deposit insurance.

The 100% cross-guarantees is a self-insurance mechanism for the banking system.[1] Cross-guarantees will use the earning power and equity capital of the banking system to protect all deposit liabilities, not just the first $100,000 of a depositor's bank balance. Cross-guarantees will effectively use risk-sensitive premiums to curb unwarranted risk-taking by individual banks. Syndicates of banks, acting as guarantors of other banks, will close banks as they approach insolvency. Prompt closure of failing banks will greatly minimize deposit insurance losses in the few banks that fail under the 100% cross-guarantee concept.

Federal deposit insurance cannot be fixed because government agencies cannot properly set risk-sensitive premium rates. Premium rates, which represent the pricing mechanism for any insurance program, are a superior risk-controlling tool when compared to increasingly ineffective government regulation. Regulators also fear and sometimes experience political intervention that delays the closure of clearly insolvent banks. Delay adds to the losses suffered by the government insurance agency. Worse, these losses come out of the taxpayers' pocket because federal deposit insurance is not backed by any real capital.

Attempting to fix federal deposit insurance will not work. At best, these fixes will finish strangle a banking system steadily losing its competitiveness from already heavy regulation. At worse, taxpayer losses from federal deposit insurance will continue as regulation strangles banks. Genuine deposit insurance reform requires shifting the control of banking risk from the regulatory cop-on-the-beat to the marketplace, and specifically to premium rates set in that marketplace.

Following a brief introduction, this paper outlines four basic objectives for any deposit insurance mechanism. It then summarizes 18 benefits 100% cross-guarantees will provide. The paper then explains why 100% cross-guarantees will offer superior loss prevention and superior loss protection when compared to federal deposit insurance. The paper then describes the mechanics of 100% cross-guarantees so that the reader will have a clearer idea of how cross-guarantees will operate on an ongoing basis. It also will discuss seven safeguards that will protect both depositors and taxpayers from all future bank insolvency losses. The paper will close by discussing how the transition from federal deposit insurance to 100% cross-guarantees can be accomplished in the very near future.

---

[1] The terms "banking" and "bank" will encompasss commercial banks, savings banks, and savings and loans (S&Ls) unless otherwise stated. These terms do not encompass credit unions and money market mutual funds.

Substantial explanatory material in this paper has been set off in boxes to avoid interrupting the flow of the main text. Boxes 1 to 16 and the appendix are referenced in the main text; boxes 17 to 24 are not. All boxes in this paper follow the main text. In the printed version of this paper, the boxes will be placed adjacent to the main text where the first reference is made to the box.

Chapter 1

Introduction

On March 8, 1933, at his first presidential news conference, Franklin Roosevelt warned about the dangers of government deposit insurance:

> "... as to guaranteeing bank deposits ... The general underlying thought behind the use of the word 'guarantee' with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the Government starts to do that the Government runs into a probable loss.... We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future."[2]

How right he was, as the crisis of the Federal Savings and Loan Insurance Corporation (FSLIC) has demonstrated so starkly. The warnings of a FSLIC crisis came as early as 1966, and there were plenty of danger signals after that. But the crisis kept building, especially as the 1980s rolled to a close. Federal deposit insurance failed badly. True, it protected savings and loan (S&L) depositors, but only at an enormous and totally unnecessary cost to American taxpayers, to healthy banks and S&Ls, and to the economy at large.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was designed to completely clean up the FSLIC mess. However, it has become increasingly evident that FIRREA will not do the job. The FSLIC cleanup has started slowly while the regulatory future of the S&L industry still is unclear.

Thus, the Congress and the Administration will have to revisit the FSLIC/S&L situation again in 1991. Future congressional action on the FSLIC mess should have one positive effect: It will focus renewed attention on the irreparable shortcomings of federal deposit insurance that President Roosevelt warned of 57 years ago. The 100% cross-guarantee concept proposed in this paper is the only reform proposal that will overcome those shortcomings: It will provide many benefits not achievable under any type of government-run insurance program while also retaining the benefits of federal deposit insurance.

Briefly, the 100% cross-guarantee concept is an industry self-insurance mechanism that will use the earnings and capital resources of the banking system to protect all deposits in every bank. Each bank will enter a cross-guarantee contract that will protect all of its deposits, including balances over $100,000, from any loss of principal, interest, or liquidity if it failed (i.e., became insolvent). Other liabilities of the guaranteed institution also could be protected under the 100% cross-guarantee contract. Each cross-guarantee contract will be issued by an ad hoc syndicate of banks called "first-tier guarantors." Each guarantor bank itself will be guaranteed by a separate syndicate of guarantor banks. Syndicates will be organized by specialized firms called syndicate agents.

---

[2] "The Public Papers and Addresses of Franklin D. Roosevelt" (New York: Random House, 1938) p. 37.

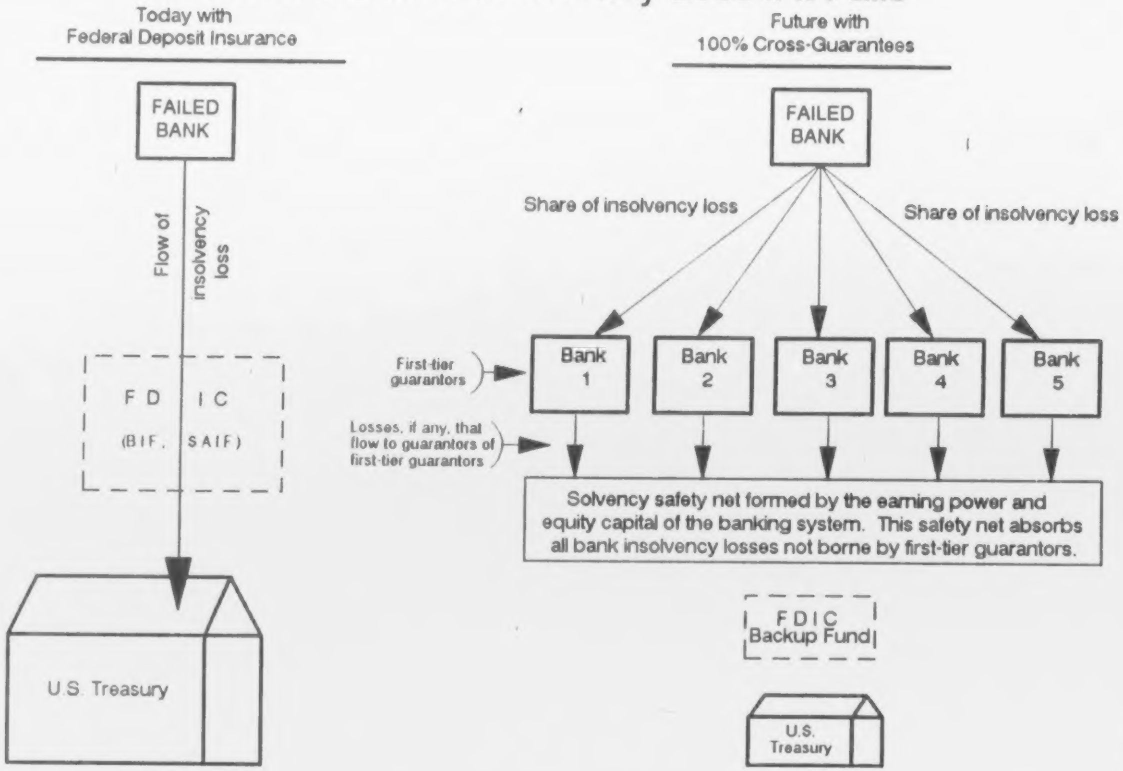
Guarantor banks will regularly collect a risk-sensitive deposit insurance premium from each of the banks they guarantee. Although risk-sensitive premiums will discourage unsound banking practices, a few guaranteed banks still will slide hopelessly towards insolvency. Thus, each cross-guarantee contract will permit the syndicate of guarantor banks to take over the guaranteed bank before it becomes insolvent. The syndicate will then be able to fully protect all deposits and other guaranteed liabilities without any loss.

If the guarantors do not take over the failing bank quickly enough, they will have to write checks to protect depositors and other guaranteed liabilities against any loss. In the rare event of a large loss, a "stop-loss" provision in each contract will permit a portion of that loss to be passed through the guarantor banks to their own guarantors. If necessary, the stop-loss provision will spread the loss across the entire banking system. In effect, the earning power and the equity capital of the banking system will form a "solvency safety net" that will permit the banking system to survive losses even more extensive than those suffered by depositors during the Great Depression. Deposits up to $100,000 can be protected further by retaining the BIF as a backup to 100% cross-guarantees.

Exhibits 1 and 2 (following this page) illustrate the 100% cross-guarantee concept and contrast it with the flow of bank insolvency losses under federal deposit insurance.

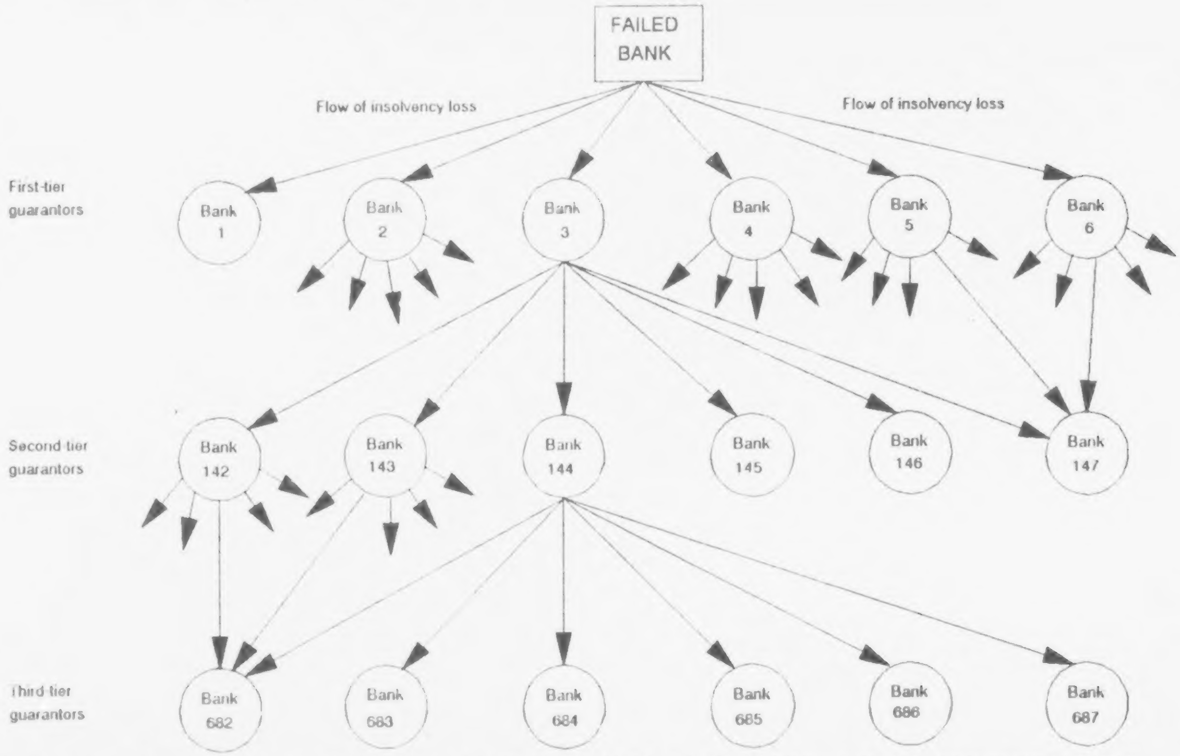
Exhibit 1

Flow of a Bank's Insolvency Loss If It Fails


Today with
Federal Deposit Insurance
FAILED BANK
Flow of insolvency loss
F D I C
(BIF, SAIF)
U.S. Treasury
Future with
100% Cross-Guarantees
FAILED BANK
Share of insolvency loss
Share of insolvency loss
First-tier guarantors
Losses, if any, that flow to guarantors of first-tier guarantors
Bank 1
Bank 2
Bank 3
Bank 4
Bank 5
Solvency safety net formed by the earning power and equity capital of the banking system. This safety net absorbs all bank insolvency losses not borne by first-tier guarantors.
F D I C Backup Fund
U.S. Treasury

Note: Dotted line around the FDIC fund denotes the fact that this fund does not actually exist because it is incorporated in the consolidated federal budget. Losses paid by the FDIC actually count as government spending when money is disbursed.

Example of How a Very Large Insolvency Loss Might Flow Through Multiple Tiers of Guarantor Banks under the "Stop-Loss" Provision of 100% Cross-Guarantee Contracts


FAILED BANK
Flow of insolvency loss
Flow of insolvency loss
First-tier guarantors
Bank 1
Bank 2
Bank 3
Bank 4
Bank 5
Bank 6
Second-tier guarantors
Bank 142
Bank 143
Bank 144
Bank 145
Bank 146
Bank 147
Third-tier guarantors
Bank 682
Bank 683
Bank 684
Bank 685
Bank 686
Bank 687

Note: Four first- and second-tier guarantors (Banks 1, 145, 146, and 147) and all the third-tier guarantors have no losses flowing out of them because their share of the failed bank's insolvency loss does not reach their "stop-loss" limit.

Exhibit 2

Chapter 2

The Basic Objectives of Deposit Insurance

Any sound deposit insurance mechanism must achieve these four basic public policy objectives:

- Maintain stability in the banking segment of the financial system while protecting depositors against bank insolvency losses;
- Protect taxpayers against bearing any portion of the insolvency loss in a failed bank;
- Enhance the political process by eliminating undesirable political interference in the banking system; and
- Promote modern, economical operation of the banking system and its principal functions, which are funds intermediation and payment transfers.

Maintain stability in the banking system while protecting depositors against losses

There are two components of stability in the banking system: the absence of bank runs, and the uninterrupted operation of the payments system. Massive runs can force banks to sell assets at fire sale losses, possibly triggering bank insolvencies.[3] If runs drain banks of their liquidity, depositors cannot withdraw funds and their checks will not be accepted by creditors or other banks.[4] If this becomes a widespread phenomenon, the payments system will freeze up, and buyers and sellers will be restricted to barter transactions.

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[3] The liquidation of the junk bond portfolios owned by insolvent S&Ls and by the bankrupt Drexel Burnham Lambert, Inc., demonstrates the impact of asset fire sales: Prices are depressed, markets become illiquid, and transaction costs rise as bid-ask spreads widen. The effect of fire sales is especially noticeable on firms employing mark-to-market accounting: Losses in the value of assets held in portfolio have to be reported in income statements just as if the assets had been sold. This reporting has the effect of lowering reported net worths and raising leverage ratios for all holders of that type of asset. For highly leveraged asset owners, such as banks, these losses can easily cause insolvency. In more widespread fire sales, this deflationary effect would cause a depression.

[4] This effectively happened in 1985 when 69 S&Ls insured by the defunct Ohio Deposit Guaranty Fund were forced to close because of illiquidity. Annual Report of the Federal Reserve Bank of Cleveland, 1985, pp. 5-24.

Central banks and other lenders of last resort can squelch bank runs once they start, but they cannot prevent runs from starting. Only deposit insurance or comparable protection can do that. To work effectively, deposit insurance must be mandatory and it must apply to all bank deposits. In effect, stable banking depends on protecting bank deposits against both bank insolvency losses and illiquidity. Box 1 describes why guaranteed liquidity is the essence of all sound deposit insurance programs. If depositors do not fear for their funds, they will not withdraw deposits from their banks during unsettled conditions or times of uncertainty. Increasingly, this form of stability also is essential to maintaining the international competitiveness of the American banking system.

Stability cannot be achieved by trying to force depositors to discipline their individual banks. The theory of depositor discipline is based on this premise: Bank depositors, or at least large depositors, will continuously monitor the financial condition of the banks in which they have money on deposit. As a bank's condition deteriorates, depositors will begin to withdraw their deposits. If these withdrawals do not force the bank to improve itself, the bank eventually will fail. Those depositors who do not make it out the door before the bank fails will suffer the bank's insolvency losses.

The theory of depositor discipline is faulty because depositors are highly risk averse with regard to their bank deposits, even though they otherwise may be risk prone. Thus, serious attempts to impose losses on depositors will cause runs on failing banks that can quickly lead to systemic instability (i.e., runs on many or all banks as everyone heads for the door at the same time). This legitimate fear of banking instability is why all industrialized nations implicitly, if not explicitly, fully protect depositors in their banks against insolvency losses so as to preserve the stability that enhances the attractiveness of their banks both domestically and internationally.

Because depositor discipline, as a practical manner, is a mirage, genuine deposit insurance reform cannot encompass any attempt to impose bank insolvency losses on depositors. Because bank deposits are a fungible commodity, one segment of a bank's deposits, such as those of more than $100,000, cannot be relied upon to serve as a disciplinary agent acting on behalf of all depositors. It is very easy for those deposits to flee a failing bank before regulators sell or liquidate it. Those fleeing deposits will create the same type of undesirable systemic instability that small depositors also will bring to the banking system if they are uninsured.[5] Box 2 describes in greater detail why depositor discipline is an ineffective alternative to 100% cross-guarantees.

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[5] In recent years, some have dismissed the significance of bank runs. See, for example, George G. Kaufman, "Bank Runs: Causes, Benefits, and Costs," The Cato Journal (Winter 1988): 582. Kaufman states, "Their [bank runs] good effects will outweigh their bad effects and help to make the banking system both safer and more

Making deposit insurance optional for banks or depositors is not a desirable first step either in deposit insurance reform. After 56 years of federal deposit insurance, the failure today of an uninsured bank or a bank with uninsured depositors could easily create instability within the financial system that could, in turn, spread to insured banks. News of runs on uninsured banks or on uninsured deposits, especially when translated into foreign languages, would tar, and thus harm, all American-domiciled banks.

Protect taxpayers against bank insolvency losses

As Franklin Roosevelt prophesied, government deposit insurance has become very costly for the American taxpayer. Although estimates of the eventual cost of cleaning up the FSLIC mess range up to $500 billion,[6] the author of this paper estimates that the present value cost of the FSLIC bankruptcy is in the range of $125 billion. Whatever the cost, it will be borne by taxpayers, including healthy banks and S&Ls that FIRREA levied with higher deposit insurance premiums (really a tax). Taxpayers should have borne none of this cost because it is possible under the 100% cross-guarantee concept to fully protect depositors and thus provide banking stability -- a legitimate public good -- without any cost to taxpayers.

Taxpayers inevitably will suffer losses from any government insurance scheme because a key precept of any insurance -- risk discrimination that is based on sound economic criteria -- conflicts with an essential precept of democratic governance: equal treatment under the law. Because of this sense of equality, the political process will consistently prevent the government insurance agency from adequately discriminating against high-risk insureds. This political phenomenon is why taxpayers cannot be protected fully from bank insolvency losses in any governmental or quasi-governmental deposit insurance scheme.

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efficient at minimum cost." However, bank runs were of sufficient concern into the early 20th century to stimulate the creation of the Federal Reserve System in 1913. Before 1913, local clearinghouses were formed by banks to minimize the liquidity draining effects of bank runs. See in particular Gerald P. Dwyer, Jr., and R. Alton Gilbert, "Bank Runs and Private Remedies," Bulletin of the Federal Reserve Bank of St. Louis (May/June 1989): 43-61.

[6] Citation to be supplied.

Enhance the political process

Federal deposit insurance has damaged the political process, in part because the owners or managers of failing banks often seek delayed closure of their institutions or other forms of regulatory forbearance. Future damage to the political process can be minimized only by shifting key deposit insurance decisions to the private sector. The political process will not be damaged if it cannot be used to forestall the closure of failing banks or the penalization of unsound banking practices.

The most important decision to shift to the private sector is when to close a failing bank. However, to fully protect the taxpayer, private sector equity capital must bear the consequences of delayed closure. In effect, marketplace forces must trigger the takeover of a failing bank as it slides hopelessly toward insolvency. It is crucial that the political process not impede this takeover process in any way because marketplace efficiency depends on bad banks failing as they become insolvent. The rest of the economy should serve as a model: The political process almost never acts to prevent or delay corporate bankruptcies.

Modernize the banking system

America suffers from an increasingly inefficient banking system. A variety of evidence documents this growing inefficiency. From the latter half of the 1970s to the 1986-88 period, the operating costs[7] of American-domiciled, deposit-taking institutions rose from 1.8% of Gross National Product (GNP) to 2.7% of GNP.[8] During 1988, this .9% increase in GNP (from 1.8% to 2.7%) consumed by these operating expenses equaled $44 billion. A substantial portion of this $44 billion increase represented the overcapacity and inefficiencies ultimately caused by federal deposit insurance and the growing volume of increasingly counter-productive regulations that attempt to protect the taxpayer from losses under this insurance program. These excess operating costs represent the consumption of economic resources that could be used more productively elsewhere in our economy.

The growing inefficiency of the banking system also is evidenced by a decline in average retail (i.e., insured) deposits in the branch offices of banks and S&Ls. After adjusting for inflation, retail deposits in the average bank and S&L office declined 5.2% from mid-

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[7] Operating costs encompass personnel, computers, occupancy costs, and so forth; they exclude interest expense and loan losses.

[8] These calculations are based on cost data the author has compiled from various regulatory sources. These data are available from the author upon request.

1986 to mid-1989.[9] Because most expenses in branches are fixed costs, this decline in average deposits per banking office has impaired the productivity of the American banking system.

Declining banking efficiency, like substantial bank insolvency losses, appears to be largely an American phenomenon. An analysis of employment in 112 of the world's largest banks for the 1980-86 period showed that employment among these banks was increasing in three nations, most rapidly in the United States and at a slower rate in Canada and Germany. Over the same period, employment was decreasing for Japanese and British banks and for a group of banks headquartered in 10 other countries.[10] The implication of this study is clear: Productivity improvements, if any, in large American banks have lagged behind the foreign experience. In effect, the study confirms for one group of banks what the author has measured for the entire banking system.

Thus, deposit insurance reform must unleash the potential for modernizing the American banking system so that American banks can regain the competitiveness they are losing rapidly both domestically and internationally. The present regulatory system, which resembles the command-and-control systems that have so thoroughly fallen into disrepute in the communist countries, must be dismantled if American-domiciled banks are to regain even domestic competitive parity with foreign-domiciled banks. Thus, deposit insurance reform must permit market forces to modernize the banking system through rapid adaptation to ever-changing market conditions while enhancing the banking system's safety and soundness.

Unfortunately for the American taxpayer and the American economy, federal deposit insurance and the regulatory process it has spawned increasingly fail to meet any of the four basic objectives for a sound depositor protection system. The technological revolution sweeping the financial services world practically guarantees a continuing deterioration of the efficacy of the bank regulatory apparatus.[11] This deterioration portends greater costs and worsening consequences for the depositor protection process, the banking system, and the overall economy unless and until the 100% cross-guarantee concept is adopted for American banking.

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[9] These figures are based on data compiled by the author. The detailed calculation is available from the author upon request.

[10] William C. Hunter and Steven G. Timme, "Employment in the World's Largest Banks," Economic Review, Federal Reserve Bank of Atlanta (January/February 1990): 2-11. This study accounted for changes in asset size and it estimated the impact of technological change; however, it was not able to account for changes in product mix as occurs when fee-based income replaces income earned on assets.

[11] The author described why this decline is taking place in "Technology, Regulation, and the Financial Services Industry in the Year 2000," Issues in Bank Regulation (Fall 1988) 13-19. Also see by the author, "The FSLIC Mess," Secondary Mortgage Markets (Winter

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1988-89): 12-15.

Chapter 3

Twenty Benefits of 100% Cross-Guarantees

To date, only one deposit insurance reform proposal, the 100% cross-guarantee concept, fully meets and actually exceeds the basic objectives of deposit insurance reform stated above. The 100% cross-guarantee concept does this by providing many new benefits while not taking away from depositors one single benefit of the existing federal deposit insurance scheme. Other reform proposals would either scale back deposit insurance or undertake the nearly impossible task of making government banking regulation more effective.

No reform proposal, except 100% cross-guarantees, will replace increasingly detrimental government regulation with effective private sector incentives that will properly reward prudent banking while deterring economically unjustifiable risk-taking by high-flying banks. One lesson the Soviet Union and Eastern Europe teach so well is that modern economies must rely on market forces rather than on government micro-management to control financial risk-taking.

The 100% cross-guarantee concept will provide 20 specific benefits to the American economy and the American people:

Benefit 1. The 100% cross-guarantees are the only way to completely integrate deposit insurance reform and the restructuring of America's financial services industry. The obsolete structure of the financial services sector of the American economy, and particularly the banking segment of that sector, desperately needs to be modernized. Modernization cannot be accomplished except to permit substantial restructuring and consolidation. Yet that cannot occur unless deposit insurance is reformed to reflect this restructuring. Federal deposit insurance cannot be reformed to accommodate the needed restructuring. The 100% cross-guarantees, however, can greatly facilitate this restructuring by completely shifting specific restructuring decisions and the associated insolvency risks to the private sector.

Benefit 2. Implementation of 100% cross-guarantees can occur much more quickly and completely than any other deposit insurance reform proposal. Many banks and thrifts will be ready to switch to 100% cross-guarantees as early as the first anniversary of the legislation authorizing 100% cross-guarantees. If legislation authorizing 100% cross-guarantees was enacted by the end of 1991, a substantial portion of America's banks could be operating with 100% cross-guarantees as early as 1993. This rapidity would represent a much fast reform of deposit insurance than anyone could hope to be accomplished by attempting to reform federal deposit insurance. The banking efficiencies possible under 100% cross-guarantees also would quickly begin to flow into the economy.

Benefit 3. The 100% cross-guarantee concept represents the only comprehensive reform of deposit insurance that has been offered to date. The 100% cross-guarantee concept will reform deposit insurance by effectively replacing federal deposit insurance with a sound, private sector insurance mechanism. All other reform proposals, by attempting to reform federal deposit insurance, are attempting to repair the irreparable.

Benefit 4. The 100% cross-guarantees will greatly increase stability in the financial system by explicitly protecting all domestic and foreign deposits in American-domiciled banks from bank insolvency losses that occur for any reason whatsoever. Thus, 100% cross-guarantees will extend deposit insurance coverage to $1 trillion of deposits not now explicitly covered by federal deposit insurance.[12] This explicit extension of deposit insurance coverage will serve to shift the entire risk of bank insolvency losses to the guarantors of banks protected by 100% cross-guarantees. These guarantors will be other banks and possibly other pools of private sector equity capital.

This full and explicit protection will eliminate the principal incentive that large depositors now have to run from banks experiencing financial difficulty, as has occurred most recently at the Bank of New England.[13] Depositors might steadily leave a declining bank because of deteriorating services or its tarnished image, but they will not run suddenly because they fear for the safety of their deposits, which is the factor that sparks panic-driven bank runs. Other liabilities of a bank, both on- and off-balance sheet, also could be fully protected under a contract for 100% cross-guarantees upon mutual agreement between a bank and its guarantors.

Benefit 5. Federal deposit insurance could be retained under 100% cross-guarantees as backup insurance for the first $100,000 of a depositor's bank balance without any risk to taxpayers. This provision would retain the confidence of small depositors in their banks. It would also allow banks and thrifts to keep the FDIC sticker on their doors, on their stationery, and in their advertisements. This backup insurance would use the existing reserves of the Bank Insurance Fund (BIF) of the Federal Deposit Insurance Corporation (FDIC) to explicitly protect depositors in failed banks, up to $100,000 per depositor, if 100% cross-guarantees ever failed to fully protect these depositors against an insolvency loss.

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[12] As of September 30, 1989, deposits that are not explicitly insured were estimated to be as follows: $609 billion of uninsured deposits in domestic offices of commercial and savings banks, $323 billion of deposits in foreign branches of commercial banks, and $68 billion of uninsured deposits in S&Ls.

[13] The Wall Street Journal, March 2, 1990.

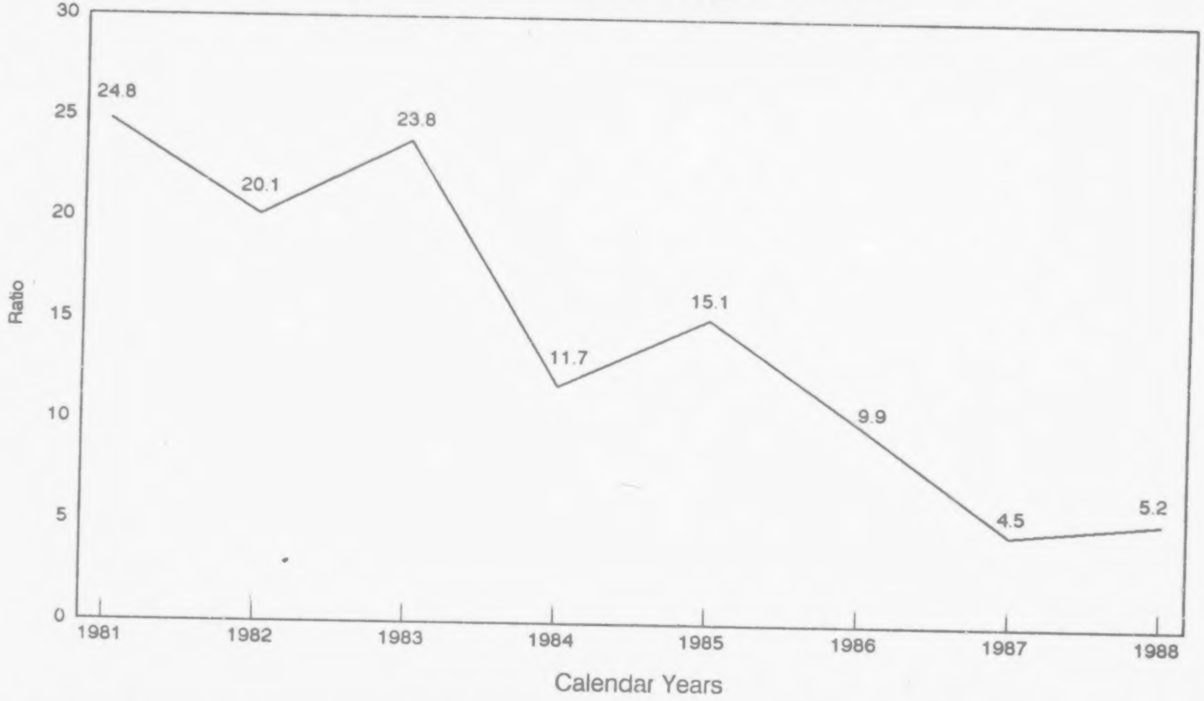
At the end of 1989, the BIF reportedly had a fund balance of approximately $13 billion, an amount equal to almost .5% of all deposits explicitly insured by the federal government (i.e., deposits below $100,000). A .5% fund balance is more than adequate for an FDIC backup fund since it almost certainly would never be drawn upon. Because the government securities transferred from the BIF to a new FDIC Backup Fund would continue to earn interest (under government accounting practices) and because the Backup Fund's losses would be zero under even the worst of circumstances, the fund's balance will grow as fast as, if not faster than, deposits protected by the Backup Fund.

Benefit 6. Failing banks and S&Ls will be taken over quickly under 100% cross-guarantees because guarantor banks will be free of the political pressures that so often inhibit regulators in closing insolvent institutions. Prompt takeover of a failing bank is essential to minimizing its insolvency loss. Prompt takeover also stops the wastefulness and criminality that frequently occur when managers of insolvent institutions make increasingly inept or fraudulent lending decisions. The Southwest is now littered with underutilized and badly built real estate that reflects incompetent or corrupt lending. The prompt takeover of failing banks and S&Ls as they approach insolvency represents one of the most important advantages of 100% cross-guarantees over politically controlled federal deposit insurance.

Benefit 7. The 100% cross-guarantees will effectively eliminate the too-big-to-fail policy for big banks. Too-big-to-fail, which protected large depositors in the Continental Illinois and FirstRepublic bank failures, for example, evolved because regulators understandably feared the systemic consequences of trying to share bank insolvency losses with large depositors in large failing banks. The 100% cross-guarantees will completely eliminate this fear because private sector capital, not taxpayer funds, will be used to protect all depositors against bank insolvency losses. Thus, it never will be necessary to draw on the FDIC Backup Fund to protect large depositors. Eliminating the too-big-to-fail syndrome, coupled with 100% cross-guarantees for all deposits, also will eliminate the complaint that the resolution of large failed banks now discriminates against community banks.

Benefit 8. The 100% cross-guarantees will build on the existing strengths of the banking system: its earning power, its equity capital, and its risk-management expertise. As Exhibit 3 (next page) shows, the earnings of all commercial banks, before income taxes and FDIC premium payments, have comfortably covered the insolvency losses reported by the FDIC even though the FDIC has reported record losses in recent years. Because bank insolvency losses will decline

FDIC Loss Coverage Ratio*



* Ratio equals pre-tax income of commercial and savings banks, plus their FDIC premium expense divided by reported FDIC losses.

Note: Between 1940 and 1980, this ratio exceeded 100:1 in every year except1974, when the ratio was 99:1.
Data Sources: Annual reports of the FDIC and "Statistics on Banking", published separately by the FDIC since 1981.

Exhibit 3

dramatically under 100% cross-guarantees, the ratio of bank earnings to insolvency losses will skyrocket.

Capital is another great strength of the banking system. On September 30, 1989, the tangible equity capital of solvent federally insured banks and thrifts was $261 billion, an amount equal to 5.8% of the tangible assets that those institutions owned on that day.[14] The nation's banks and thrifts also possess substantial expertise and experience in assessing banking risks. This expertise is why the banking system has accumulated as much earning power and capital as it has.

Benefit 9. The 100% cross-guarantees will prevent any taxpayer losses under federal deposit insurance and thus effectively remove federal deposit insurance as a contingent liability of the federal government. In effect, 100% cross-guarantees can deliver what few believe is possible: better protection for all depositors and for the financial system at no cost to American taxpayers. The 100% cross-guarantees will achieve this benefit by inserting, between the depositors of any one bank and the U.S. Treasury, the earning power and equity capital base of American-domiciled banks. This earning power and capital together will place a "solvency safety net" under the banking system through which the insolvency losses of failed banks will not penetrate. The equity capital component alone is more than enough to absorb bank insolvency losses exceeding the losses that would be experienced during another Great Depression. Exhibit 1 (following page 8) contrasts the present flow of bank insolvency losses into the Treasury with the solvency safety net that will be constructed by 100% cross-guarantees.

Benefit 10. The risk-sensitive premiums charged for 100% cross-guarantees will promote more efficient use of economic resources by deterring economically unrewarding lending and investing by banks and thrifts. Economically unrewarding lending is evidenced in banks by foregone interest income and loan losses. Flat-rate deposit insurance premiums can lull a bank into not pricing its riskier loans and investments to fully compensate for the risk it is assuming. With flat-rate premiums, the interest rate charged to a borrower does not fully reflect the risk that the loan represents to the deposit insurer. As a result, loans and investments are often made that would not be made if the interest rate were set at a higher rate to fully reflect the cost of risk-sensitive deposit insurance. Thus, risk-sensitive premiums will go a long way toward ending interest rate underpricing. This, in turn, will substantially reduce wasteful lending practices that have been so painful to banks, to the taxpayer, and to the economy.

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[14] Figures are based on financial data filed with banking regulators.

This salutary effect of risk-sensitive premiums could potentially trim loan loss expense in banks and thrifts by as much as $10 billion annually,[15] an amount equal to one-third of the average annual loan loss expense that banks recorded between 1984 and 1988. Reducing loan losses by this magnitude will not entail denying credit to worthy borrowers; it can be achieved by the wiser lending practices that risk-sensitive premiums will promote.

The positive effect of risk-sensitive premium rates on lending and investing also will help to moderate the boom-bust effect on local and regional economies that flat-rate premiums do not discourage. The Southwest would not be experiencing a real estate depression today if S&Ls, in particular, had been paying risk-sensitive premiums over the last decade and lending more prudently as a result. Exhibit 4 (see following page) shows how S&L lending in Texas rose on the downside of the Southwest energy boom. That lending explosion never would have occurred with genuine risk-sensitive deposit insurance premiums.

Benefit 11. The 100% cross-guarantees will permit individual banks to tailor their own "on-balance-sheet" equity capital to their own risk profile. All capital standards, including risk-based standards being implemented in industrialized countries under the Basle accord,[16] essentially reflect the one-size-must-fit-all mentality of all regulation even though the risk profile of individual banks varies increasingly. The shortcomings of risk-based capital standards now being imposed on banks by the regulators are described in Box 3.

Worse, the higher capital levels sought by regulators actually make banking riskier rather than safer. This risk is the case because banks cannot earn an adequate return on less-risky assets because the marketplace has determined that these assets do not need as much capital backing as banking regulations require. Thus, the regulatory ratcheting up of capital standards steadily drives banks toward increasingly risky loans and investments that, in the short-term at least, appear to offer the higher net interest margins needed to pay for the higher capital levels. Eventually, these higher net interest margins will shrink as realized losses exceed projections. This problem is exacerbated by a tax system that explicitly

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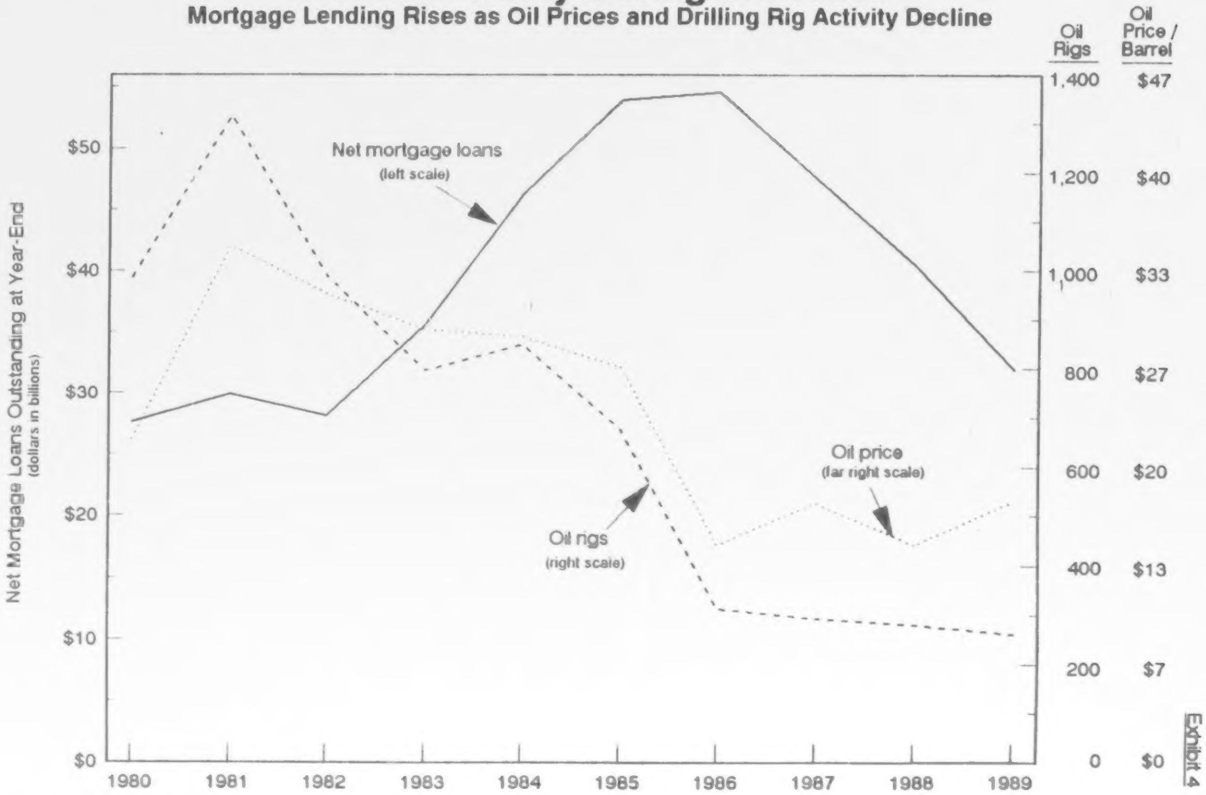
[15] Recorded loan loss expense for the 1984-88 period was as follows: commercial banks -- $108 billion, S&Ls -- $42 billion, and savings banks -- $2 billion. On the basis of data for the first nine months of 1989, loan loss provisions in 1989 quite likely approached or even exceeded $40 billion.

[16] The Basle standards are highly simplistic. These standards reflect only credit risk; with just a few exceptions, these standards treat all private sector credit risks as if they were the same.

Texas Economy During the 1980s

Mortgage Lending Rises as Oil Prices and Drilling Rig Activity Decline



Sources: Department of Energy, Hughes Tool Company, and the Federal Home LoanBank Board.

Exhibit 4

discriminates against equity capital through the double taxation of corporate dividends.

The 100% cross-guarantee concept, however, offers individual banks the opportunity to match their on-balance-sheet equity capital to the riskiness of their balance sheets. In effect, risk-sensitive premiums charged for 100% cross-guarantees will permit individual banks to strike the optimal balance between risk and capital. If a bank's riskiness pushes up its 100% cross-guarantee premium rate, the bank can bring that rate down by reducing the riskiness of its balance sheet and/or by raising new capital.

The author expects that banks will seek higher returns on the capital that they commit to their guarantor activities than they will seek on their own loans and investments. If this is the case, guaranteed banks generally will find it cheaper to cushion their loans and other risk assets with on-balance-sheet equity capital rather than by paying a higher premium rate.

The overall effect of matching risk with capital at the bank level will be to reduce the riskiness of the banking system. This matching will reduce substantially the moral hazard of deposit insurance that exists because of the flat-rate premium now charged for federal deposit insurance.

Benefit 12. Risk-sensitive pricing will eliminate the need for any depositor discipline because all risk and cost of bank failure will be imposed on guarantor banks. As discussed in Box 2, depositor discipline, which really is creditor discipline, is a poor substitute for equity capital discipline. Guarantors will provide equity capital discipline because they will be placing their equity capital at risk every time they enter a 100% cross-guarantee arrangement.

Benefit 13. Risk-sensitive pricing will eliminate substantially all of the cross-subsidy that now flows from good banks and thrifts to the bad. Under present law, this indefensible cross-subsidy, which is caused by flat-rate deposit insurance premiums, will amount to $3-$4 billion in 1991.[17] Risk-sensitive premiums will impose on the riskier banks most, if not all, of the insolvency losses these banks, as a group, eventually will incur. This attribute will end the enormous cross-subsidy that now flows from prudently managed and adequately capitalized banks to risky banks as a result of the flat-rate deposit insurance premium. Thus, sound banks will pay far less for their 100% cross-guarantees than they are now doomed to pay for federal deposit insurance.

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[17] On the basis of conservative deposit growth assumptions, in 1991 commercial and savings banks will pay about $3.8 billion in BIF premiums while the new Savings Association Insurance Fund (SAIF) will collect about $2.2 billion in premiums, for a total of $6 billion in deposit insurance premiums. This amount will equal about .1% of GNP. Of this $6 billion amount, the author estimates that in 1991 sound banks and thrifts will pay at least $3 billion and perhaps as much as $4 billion too much for their deposit insurance because of flat-rate premiums.

Benefit 14. The 100% cross-guarantees will greatly improve the operating efficiency of individual banks and the entire banking system. An enormous, yet hidden, cost of federal deposit insurance is the excessive and outdated regulation of banks, which has added billions of dollars annually to their operating costs.

The 100% cross-guarantees will free banks of burdensome government regulations, thus enabling them to operate more efficiently.[18] Even though risk-sensitive premiums will be the principal regulatory feature of 100% cross-guarantees, cross-guarantee contracts will contain restrictions that will be tantamount to government regulations. However, marketplace competition will continually squeeze out inefficient, unnecessary, and counter-productive restrictions in cross-guarantee contracts. No such comparable cleansing process now exists to minimize the productive drag of government regulation.

Benefit 15. The 100% cross-guarantees will enormously enhance the competitiveness of American-domiciled banks, particularly inside the United States where foreign-domiciled banks are steadily increasing their share of the banking business. On June 30, 1989, foreign-domiciled banks held 22.6% of U.S. commercial banking assets.[19] Cross-guarantees will pay a major dividend to the American economy by permitting banks to escape the high bank insolvency losses and the wasteful regulation that increasingly harms the domestic and international competitiveness of American banks.[20]

Eliminating just one-half of the increase in bank operating expenses from the late 1970s to the present would reduce bank operating expenses by $22 billion in 1988 dollars, or almost .5% of GNP. This figure is probably an underestimate of the hidden waste and inefficiency ultimately caused by federal deposit insurance and its regulatory web. The human and material resources released as a result of cross-guarantees can readily be used elsewhere in the economy.

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[18] A recent narrative description of these regulatory burdens is contained in Evelyn F. Carroll, John P. Danforth, Carter H. Golembe, and P. Michael Laub, "The Burden of Bank Regulation," American Bankers Association, Washington, D.C., August 1989.

[19] James R. Kraus, "Foreign Banks Still Seizing Greater U.S. Market Share," American Banker (February 27, 1990):1.

[20] "U.S. Banks Are Losing Business to Japanese at Home and Abroad," The Wall Street Journal, October 12, 1989.

Even if bank insolvency losses under federal deposit insurance miraculously receded in the 1990s to the levels experienced in the 1970s, as some people have predicted,[21] the hidden costs and inefficiencies of increasingly detailed bank and S&L regulation still will merit shifting depositor protection to 100% cross-guarantees. As it is, the domestic and international competitiveness of our banks and S&Ls is being badly damaged by wasteful costs and by the burdensome regulations of federal deposit insurance. This damage also trims the output of the American economy, a condition that harms every American. Cross-guarantees will place a premium on operating more efficiently while the cross-guarantee enabling legislation effectively will permit banks to operate more efficiently.

Specifically, 100% cross-guarantees will allow American banks to operate more efficiently than their foreign competition by enabling American banks to leapfrog from a uniquely expensive and antiquated regulatory structure to a marketplace mechanism that will permit far more efficient and safer banking operations than any existing regulatory system operating anywhere in the world. Even as other nations adopt 100% cross-guarantees, which competitive forces will dictate, American-domiciled banks will still be net beneficiaries because they will be playing on a level playing field, not on one increasingly tilted against them.

Benefit 16. The 100% cross-guarantees will greatly enhance the ability of individual banks to innovate at a pace that suits each bank. No longer will banking regulation impede innovation. Instead, risks associated with innovation will be assessed and priced in private contractual negotiations between a bank and its guarantors. This marketplace flexibility, in turn, will enable individual banks to better serve users of financial services.

Benefit 17. The 100% cross-guarantees will measurably lower the cost of funds for all banks, especially the smaller ones, without any taxpayer subsidy whatsoever. One benefit of 100% fail-proof cross-guarantees will be to make every guaranteed bank an AAA-rated institution. Thus, every one of these banks will be able to raise funds more cheaply than all but a few American corporations, including one bank (Morgan Guaranty Trust Company), that have earned an AAA credit rating solely on the basis of their own capital strength. Even at that, the funding cost difference between AAA-rate corporations and guaranteed banks will be only a few basis points (1 basis point equals .01%).

By another measure, the financial markets will narrow the interest rate differential between U.S. Treasury debt and large negotiable certificates of deposits of the same maturities. During

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[21] Some trade association and FDIC officials have projected that the premium rate charged by BIF could drop to between 2 and 4 basis points by 1993. American Banker (August 14, 1989):1.

1988 and 1989, that differential or spread was about 1.0%, or 100 basis points. A reduction of 20 basis point in this spread, when applied to all bank and thrift deposits, will lower bank and thrift funding costs and will, ultimately, lower the interest rate paid by borrowers by $7-$8 billion annually. These savings will more than offset the $2.7 billion of annual taxes that are currently levied on bank deposits in the form of non-interest-bearing balances that banks are required to maintain in Federal Reserve banks.[22] This savings, in turn, will make banks more competitive lenders than they now are.

Reducing a bank's cost of funds by 20 basis points -- to 80 basis points over the cost of Treasury borrowings -- seems quite reasonable given that the debt of certain federal agencies, which has only the implicit backing of the U.S. Treasury, usually yields 20-40 basis points more than Treasury debt.[23] Once the cross-guarantee system is well established, negotiable bank certificates of deposit (CDs) will become interchangeable, thus creating a vast and highly liquid market for these CDs. This liquidity should bring the cost of bank deposits and borrowings down to the range that federal agencies now enjoy.

Benefit 18. The 100% cross-guarantees will have a favorable impact on the federal budget deficit. Under FIRREA, banks insured by the BIF are scheduled to begin receiving a premium rebate once the BIF balance reaches 1.25% of BIF-insured deposits. Under various economic scenarios, rebates could begin in the 1993-95 period. Once rebates begin, the BIF will run a net budget deficit of several hundred million dollars to as much as one billion dollars per year, after taking into account the tax deductibility of federal deposit insurance premiums.[24] However, BIF will not add to the budget deficit if it serves only as a backup fund for 100% cross-guarantees.

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[22] During the first 10 months of 1989, required non-interest-bearing reserve balances maintained at Federal Reserve banks by the nation's banks and thrifts averaged $33.04 billion. This amount, multiplied by an average 8.2% interest rate on 3-month Treasury bills (secondary market yield) for this same 10-month period, indicates that depository institutions currently suffer a $2.7 billion annual loss of income on the non-interest-bearing deposits that they are required to hold at Fed banks. This lost income is a tax that effectively adds about 6 basis points to annual bank operating costs per dollar of assets.

[23] The 12 federal home loan banks, the Farm Credit System, and Fannie Mae are the principal federal agencies whose debt is implicitly backed by the U.S. Treasury.

Benefit 19. The 100% cross-guarantee concept can easily be extended to protect the liabilities of all financial services providers, including securities firms, money market mutual funds, and insurance companies. Technology is rapidly eroding the efficacy of financial services regulation across the entire financial services sector of the American economy. Solvency problems increasingly stalk all types of financial services firms, including securities firms, money market mutual funds, and insurance companies. The existing mechanisms for protecting depositors and insureds in these firms are increasingly stressed, particularly in the insurance industry. Rather than fixing these protective mechanisms or developing new governmental mechanisms, the 100% cross-guarantee concept can easily be extended to encompass all financial service providers. Besides bringing greater strength and efficiency to these service providers, this broadening of 100% cross-guarantees would actually strengthen it by providing it with more diverse financial risks and a larger capital base with which to absorb those risks.

Benefit 20. The 100% cross-guarantees will relieve the political process of the increasingly embarrassing pressures placed on it in recent years to intervene in the banking system, usually on behalf of bankrupts and poor performers and always with disastrous results. Removing this pressure will help to restore the increasingly torn political fabric of America; it is an essential reason why 100% cross-guarantees must be used to bring perestroika to the financial services sector of the American economy.

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[24] Once BIF rebates begin, BIF will retain just enough of its earnings to hold constant the ratio of BIF reserves to BIF-insured deposits. Under various economic scenarios for the 1990s, the earnings the BIF retains each year will be less than the tax reduction banks will obtain when they deduct their BIF premiums on their corporate tax returns. Calculations by the author of this deficit effect will be supplied upon request.

Chapter 4

The Superiority of the 100% Cross-Guarantee Concept

The 100% cross-guarantees will be superior to federal deposit insurance for two reasons: They will provide superior prevention of bank failures in the first place, and they will furnish superior protection of depositors and the financial system on those rare occasions when prevention does not keep a bank from failing.

Superior loss prevention

The 100% cross-guarantees, using marketplace forces, will prevent bank failures in three sequential steps.

Step 1. Day in and day out, risk-sensitive premiums charged to banks by their guarantors will discourage banks from making imprudent loans and investments (i.e., where the loan or investment yield will not fully cover the cost of funds, of overhead expenses, and of reasonably expected losses associated with that type of loan or investment).

Under the terms of a 100% cross-guarantee contract, the risk-sensitive premium will represent a claim on the pre-tax earnings of the guaranteed bank. This claim come before any claim stockholders will have on their bank's earnings. Thus, all other things being equal, a bank's earnings attributable to its stockholders will decline as the risk-sensitive premium rises.

Risk-sensitive premium rates that effectively reflect leading indicators of banking risk will rise slowly enough to give banks sufficient time to undertake corrective action that will in turn reduce the premium rate. A bank will have sufficient time to respond to its increasing riskiness because banks do not fail overnight; quantifiable trends in a bank signal a bank's decline months, if not years, before it becomes insolvent. This phenomenon is why bank solvency is a highly insurable risk, certainly more insurable than most property and liability risks assumed by insurance companies. In Exhibit 5 (next page), Bank 1 (top) illustrates the corrective effect of a rising cross-guarantee premium rate.

The political process will never tolerate truly risk-sensitive premiums because those banks who would pay the most would squawk the loudest, and they will be rewarded with lower premium rates.[25] Thus, government-backed deposit insurance always will lack the pricing discipline that is essential in any business to containing

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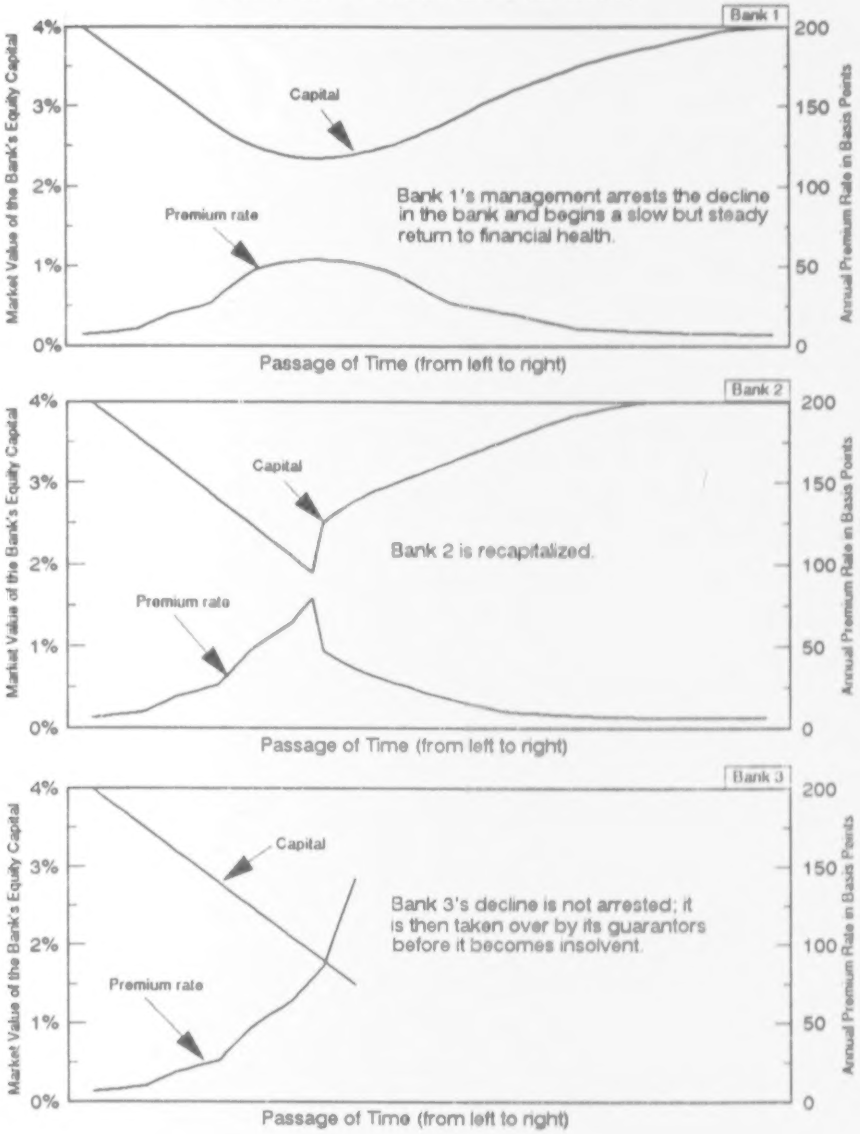
[25] To this day, one of the best discussions of the shortcomings of risk-based premiums established by a government agency is found in Kenneth Scott and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," Stanford Law Review 23 (May 1971): 890-95, particularly.

Exhibit 5

Interaction Between Premium Rates and Capital Levels for Three Banks

(All three banks are declining at the same rate until they pull out, are pulled out, or do not pull out of their decline.)



unwarranted risk-taking. As the 1980s demonstrated so well, regulation is a less and less effective substitute for accurate pricing in preventing bad banking.

Step 2. If a bank persists in operating in an imprudent manner, the rising premium rate for its cross-guarantees will soon invoke the second preventative feature of 100% cross-guarantees: equity market intervention.

Equity market intervention, in effect marketplace feedback to the bank's management, will take several forms. Boards of directors will respond to a rising premium rate by pressing management to curtail imprudent lending and investing, improve earnings by cutting expenses, or, if necessary, raise additional equity capital. Directors will exert this pressure, because if they do not, stockholders and the stock market will. Dissident stockholders in a declining bank, for example, might mount a proxy fight to replace the current directors and management or they might sue the directors for negligence.

Because flat-rate federal deposit insurance premiums do not reflect risk, they do not force a timely marketplace recognition of a bank's imprudent risk-taking.

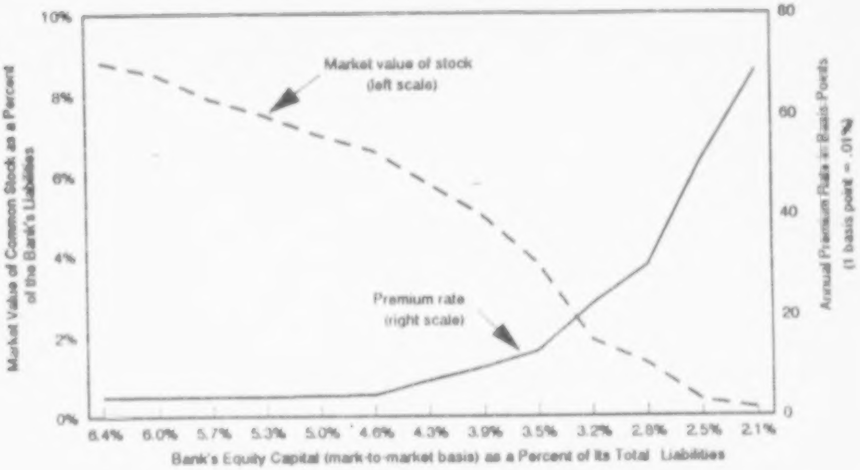
Another form of equity market intervention will exert even greater pressure on management to turn the bank around: The bank will become a takeover target because a rising premium rate will drive down the bank's stock price. The bank will be an attractive takeover target because buying the bank cheaply and then recapitalizing it will bring its new investors very high returns: The new capital invested in the bank will lower its premium rate for its 100% cross-guarantees. Lower premiums will translate into greatly improved earnings that will accrue to the benefit of the new investors. The top portion of Exhibit 6 (next page) illustrates the impact that a rising premium rate will have on a guaranteed bank's stock price. The bottom portion of Exhibit 6 illustrates the likely returns, easily in excess of 100%, that will accrue to equity capital invested in a bank experiencing a very high premium rate. Bank 2 (the middle bank) in Exhibit 5 (following page 25) illustrates the favorable impact of a fresh equity capital investment in a declining bank.

Federal deposit insurance actually discourages fresh capital investment in a marginal bank because it does not reward the new investors with lower deposit insurance premium rates.

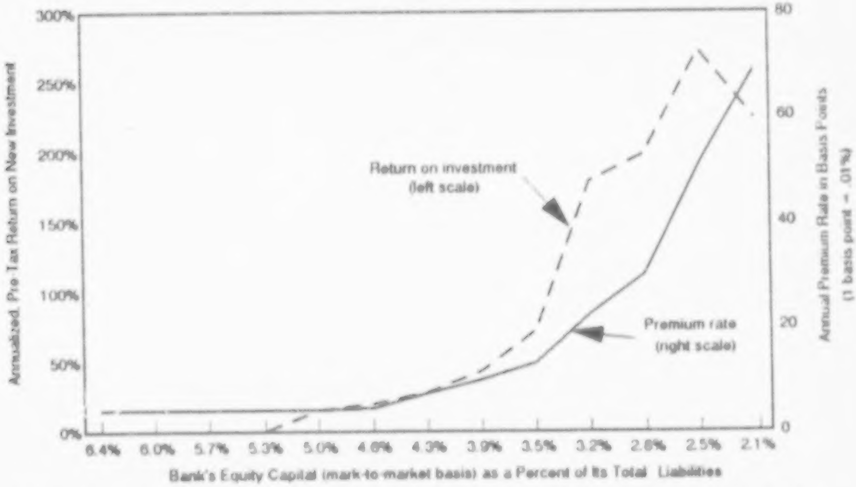
Step 3. If equity market intervention does not arrest a bank's slide toward insolvency, then the third preventative feature will kick in: The bank's guarantors will take over the bank, almost certainly before the bank actually becomes insolvent. The guarantors will then sell the bank to new and well-capitalized owners or, in very rare cases, they will actually liquidate the bank by paying off its depositors and selling its assets. Guarantor takeovers should be rare; guarantor losses, when takeovers occur, should be even rarer.

Exhibit 6

Impact of Risk-Sensitive Premiums on the Market Value of the Common Stock of a Guaranteed Bank



Pre-tax Returns Earned on New Investment in a Guaranteed Bank as the Premium Rate for Its 100% Cross-Guarantee Rises*



* Assumes (1) new capital investment shifts the market value of equity capital four percentage notations to the left on the horizontal scale and (2) new investment receives proportionally twice as much stock as existing stockholders.

Bank 3 (the bottom bank) in Exhibit 5 (following page 25) illustrates a bank that finally is taken over by its guarantors after failing to pull out of its nosedive toward insolvency.

Prompt, no-nonsense takeovers of failing banks will represent a major improvement over federal deposit insurance. Governments throughout the world are notably reticent to close failing businesses of any type because those who will be adversely affected by the closing will vigorously invoke the political process to block or at least delay that closing. Federal deposit insurance is a dramatic example, as witnessed by the hundreds of S&Ls that have continued in business years after they became insolvent.[26]

Superior loss protection

Actual bank insolvency losses under 100% cross-guarantees will be minuscule. This small loss will be a vast improvement over the recent federal deposit insurance experience that, unfortunately, has soaked the taxpayer with enormous S&L insolvency losses that have been unnecessarily compounded by delayed closure of clearly insolvent institutions. As shown in Exhibit 7 (see following page), by the late 1980s, federal deposit insurance losses, expressed as a percentage of total bank deposits and GNP, reached the level of losses that depositors in failed banks experienced during the Great Depression, even though the 1980s experienced far more favorable economic conditions than the early 1930s.

The current earnings of guaranteed banks will be the first of two cushions to absorb any guarantor losses in insolvent banks. The pre-tax, pre-FDIC assessment income of commercial and savings banks is more than adequate under almost any economic scenario to comfortably absorb all bank insolvency losses.

Exhibit 3 (following page 17) demonstrates that during the 1980s, when FDIC losses reached totally unnecessary and unjustifiable heights, the earning power of the nation's commercial and savings banks could have easily absorbed the insolvency losses recorded by the FDIC. The relatively low ratio shown in Exhibit 3 for 1987 and 1988 reflects both the depressed bank earnings in 1987 and the record FDIC losses in 1988; this ratio almost certainly rose in 1989.

The experience of the FSLIC has been excluded from this analysis because it represents such an aberrant public policy failure. As Box 4 demonstrates, the 100% cross-guarantees concept would never have tolerated the borrow-short-to-lend-long financing strategy that guaranteed a very expensive demise for America's S&Ls. The 100%

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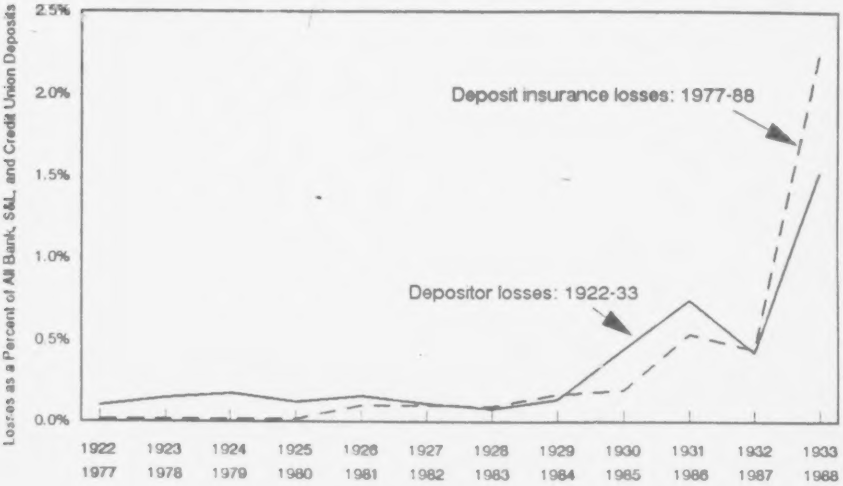
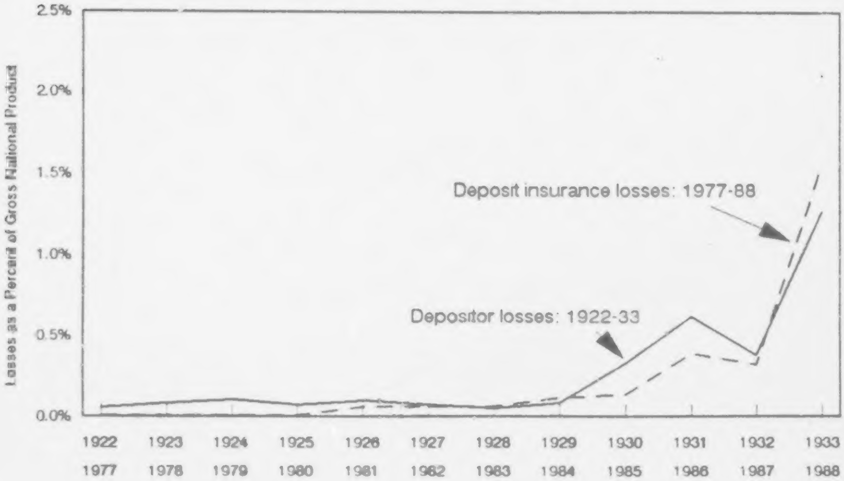
[26] One analysis of 205 S&Ls that were resolved in 1988 by the Federal Home Loan Bank Board showed that these S&Ls on average had been insolvent for four years before they were resolved. James R. Barth, Philip M. Bartholomew, and Carol J. Labich, "Moral Hazard and the Thrift Crisis: An Empirical Analysis," Consumer Finance Law Quarterly Report (Winter 1990): 22-34.

Exhibit 7

Depositor/Deposit Insurance Losses as a Percent of Deposits



Depositor/Deposit Insurance Losses as a Percent of GNP



cross-guarantees would have completely prevented the S&L/FSLIC debacle by never permitting S&Ls to become so dangerously financed.

The history of the U.S. national banks (i.e., those banks chartered and regulated by the Comptroller of Currency) further demonstrates this point. Since 1869, the national banks collectively have lost money in only four years, 1931-34.[27] The published earnings history for commercial banks that belong to the Federal Reserve system,[28] dating back to 1919, shows a similar experience: Federal Reserve members, taken as a whole, reported losses only in the years 1932-34.[29] The banking system losses in the early 1930s were caused by deflation-driven losses on loans and securities. Exhibit 8 (see following page) shows the relationship between the severe price deflation of the early 1930s and the deposits in banks that failed as a result of this deflation.

This equity capital of the banking system will be the second cushion to absorb bank insolvency losses in the highly unlikely event that the current earning power of the banking system is not adequate to fully absorb bank insolvency losses. Thus, the "solvency safety net" formed by 100% cross-guarantees will establish a crucial principle that is now absent in federal deposit insurance: The equity capital of the entire banking system always will be at risk to protect the principal and liquidity of every bank's deposits. This capital will be more than adequate to absorb bank insolvency losses should there be insufficient earnings in the banking system to absorb those losses. The capital base underpinning the risks of the banking system can be broadened even more if nonbank organizations also serve as guarantors.

This aspect of the 100% cross-guarantee concept strongly accords with and reinforces the universal belief that safe-and-sound banking requires the presence of adequate amounts of equity capital on the balance sheet of individual banks. Under federal deposit insurance, however, only the wealth of taxpayers is explicitly at risk once a bank's capital is consumed by its own losses. Today, if a bank exhausts its capital and thus fails, its losses effectively add to the federal budget deficit, as shown in Exhibit 1 (follows page 8).

The failure to quickly and automatically replace the evaporated capital of a failing bank with fresh equity capital is a fundamental failing of bank supervision and regulation. Bank regulators can look only to taxpayers' monies to protect depositors. In a guaranteed

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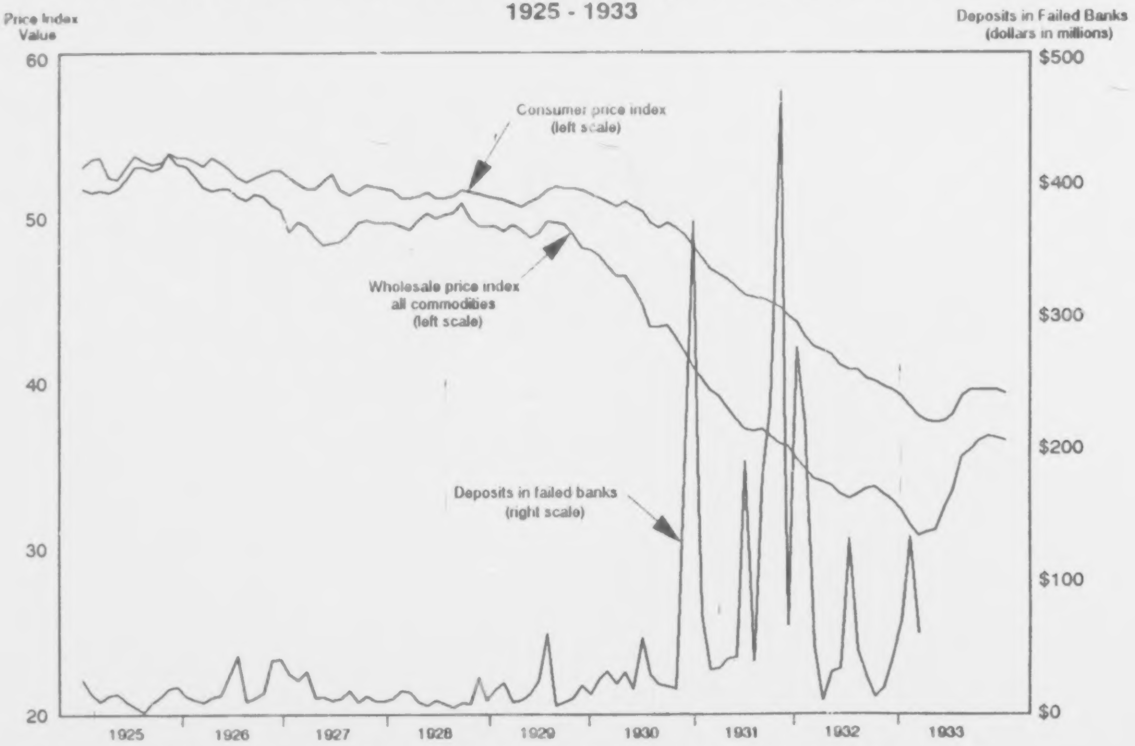
[27] See "Historical Statistics of the United States, Colonial Times to 1970," Bureau of the Census, Series X773, p. 1040; see also annual reports of the FDIC since 1970.

[28] All national banks plus all state-chartered banks that voluntary join the Federal Reserve System.

[29] "Banking and Monetary Statistics, 1914-1941," Board of Governors of the Federal Reserve System, Table 57, p. 263.

Price Trends Contrasted with Deposits in Failed Banks

1925 - 1933



Note: Deposits in failed banks are shown through February 1933 to eliminate the distorting effect of the banks closed during the March 1933 bank holiday.

Data Sources: Price Indices, Bureau of Labor Statistics; deposits in suspended banks, Federal Reserve Bulletin, September 1937, p. 909.

Exhibit 8

bank, the equity capital of a failing bank's guarantors will automatically be used to protect the bank's depositors against insolvency losses.

Box 5 demonstrates why bank equity capital can place an extremely substantial solvency safety net under the nation's banking system. Box 6 demonstrates that the equity capital of the banking system would have been sufficient during the Great Depression to absorb all bank insolvency losses during that era and still have left the banking system with sufficient capital to have helped restart the American economy once it effectively went off the gold standard in March 1933.

The solvency safety net constructed by cross-guarantees and illustrated in Exhibit 1 (follows page 8) will dramatically reduce public policy concerns about capital adequacy in the banking system even if participation in the solvency safety net is limited to banks. The capital adequacy of individual banks always has been the public policy concern expressed in various capital standards because federal deposit insurance does not and cannot place a solvency safety net under individual banks or the entire banking system. The new international risk-based capital standards formulated by the banking supervisors of the major nations under the so-called Basle accord are merely the latest attempt by regulators to fine-tune their increasingly antiquated concept of capital adequacy (see Box 3).

With cross-guarantees, capital adequacy concerns from a public policy perspective will focus exclusively on the aggregate amount of current earnings and equity capital in the banking system. The earnings and capital of an individual bank will no longer be a matter of regulatory concern. The earning power and especially the amount of capital in an individual bank will, of course, greatly affect the premium rate that bank is charged for its cross-guarantees.

The solvency safety net that can be formed within the banking system actually will offer depositors and the entire economy better protection against bank insolvency losses than the federal government can provide in today's environment. Better protection will be the case because, in recent decades, the federal government has become both heavily indebted and the undercompensated insurer of last resort for much of the American economy. Further, because the banking business is so integral to the entire economy, isolated shocks to the banking system that economists speak of so frequently simply cannot occur. Instead, problems in the banking system reflect problems in major sectors of the economy, if not in the entire economy. These problems also will be very costly to the Treasury in terms of lower tax collections and/or higher spending.

In addition, the federal government has become the de facto insurer of more than $2 trillion of civilian government infrastructure in the United States.[30] Finally, when natural disaster strikes, a substantial portion of losses to private sector property are tax deductible, which further reduces federal revenues. Thus, despite popular myth, the federal government cannot be relied upon as a catastrophic insurer for the banking system.

Two major disasters in the fall of 1989, Hurricane Hugo and the San Francisco Bay area earthquake, dramatically illustrate the seriously overtaxed ability of the federal government (really the federal taxpayer) to serve as a catastrophic insurer to any sector of the economy. These disasters triggered supplemental congressional appropriations for disaster assistance of almost $4 billion.[31] Tax deductions stemming from losses related to these disasters will cost the Treasury hundreds of millions if not a few billion dollars more. Yet at the same time these disasters had a negligible impact on the earnings of American banks and thrifts, and they caused no known bank or thrift failures. The outcome of these events demonstrates clearly the greater capacity of the banking system to absorb losses from major national catastrophes. This capacity will be even greater if nonbank firms also become guarantors of banks.

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[30] At the end of 1988, the depreciated current replacement cost of federal and state investment in public infrastructure (excluding the military) was $2.07 trillion. U.S. Department of Commerce, Survey of Current Business, August 1989, Table 14, p. 92.

[31] "Budget of the United States Government, Fiscal Year 1991," p. 248.

Chapter 5

The Mechanics of 100% Cross-Guarantees

This section of the paper will summarize the mechanics of how 100% cross-guarantees will operate on a day-to-day basis.

The 100% cross-guarantee contracts will be created in a dynamic marketplace in which all banks will have to obtain a cross-guarantee contract to operate a deposit-taking business. Most of these banks, but not necessarily all, also will participate in this marketplace as guarantor banks. Thus, banks will be both issuers and beneficiaries of 100% cross-guarantees.

Cross-guarantees will be provided to a bank by a syndicate of other banks called "first-tier guarantors." As will be discussed below, it may be desirable to permit other types of business firms to become guarantors. These guarantors will contract voluntarily with the guaranteed bank to protect all of the bank's domestic and foreign depositors against any loss of principal, interest, or liquidity (see Box 1). This extension of deposit insurance to deposits in foreign branches of American banks will be an important competitive advance for American banks because these deposits have not been protected explicitly by federal deposit insurance.

The 100% cross-guarantees also will protect all guarantor commitments of a bank. Thus, every guarantor bank itself will be guaranteed by yet other banks.

Although 100% cross-guarantees will protect all deposit liabilities of a bank, cross-guarantees also could be extended to protect other types of bank liabilities such as notes issued to the public. Guaranteed banks probably will want to extend the cross-guarantee commitment to their nondeposit liabilities, for an additional premium, because this relatively inexpensive credit enhancement could significantly trim the bank's interest rate on its guaranteed borrowings.

Functionally, the 100% cross-guarantee contract will be similar to a standby letter of credit issued by a bank. Payments are made under a standby letter of credit only when the beneficiary of the letter of credit has incurred a previously designated type of loss.

Like all insurance contracts and standby letters of credit, though, the cross-guarantee contract effectively will be an option on the equity capital of the guarantor banks (see Box 7).

Cross-guarantee contracts will have four parties: the guaranteed bank; a syndicate of guarantors; the agent for the syndicate of guarantors, called the syndicate agent; and the FDIC as cross-guarantee regulator.

Syndicate agents will be specialized firms formed to serve the cross-guarantee marketplace. Nothing closely comparable to syndicate agents now exists, but the marketplace has repeatedly demonstrated that new types of business firms will emerge to meet new needs. Syndicate agents will organize the syndicate of guarantors, negotiate the terms of the cross-guarantee contract on behalf of the guarantors, monitor the performance of the guaranteed bank on behalf of the syndicate, and deal with a failing bank on behalf of the syndicate. Syndicate agents will have a fiduciary responsibility to guarantors (i.e., to the members of the guaranteeing syndicate) rather than to the guaranteed bank. Thus, at all times, a syndicate agent will act on behalf of the guarantors, not the guaranteed bank. Since there are 13,000 banking organizations in the United States,[32] several score or more syndicate agents may form to serve the cross-guarantee marketplace.

Syndication of the 100% cross-guarantee risk

Syndicate agents will organize guarantor syndicates in a manner comparable to the way in which insurance risks are syndicated at Lloyd's of London (see Box 8). That is, an agent will solicit banks to join a cross-guarantee syndicate for a specified institution such as Citibank, Chase Manhattan, or the First National Bank of Oshkosh. Each bank that joins a cross-guarantee syndicate will agree to assume a certain portion of the insolvency risk in the guaranteed bank in exchange for that same portion of the premium paid by the guaranteed bank. Thus, syndicates of guarantor banks will be ad hoc in nature in that each syndicate will have a membership composition and will have risk-sharing proportions that will be unique to that syndicate.

Because the cross-guarantee syndication marketplace will be very competitive, it probably will not need to be regulated, even though the terms of cross-guarantee contracts will be regulated by the FDIC.

Large- and middle-size banks ($250-$500 million in asset size and above) most likely will have their risks syndicated on a bank-by-bank basis. However, it will be more economical to group smaller banks when syndicating their cross-guarantee risk. Box 9 describes how this group syndication process will work.

There is sufficient capital in the banking system so that even the biggest banks will have sufficient alternatives among prospective guarantors. Thus, a syndicate agent will be able to assemble a syndicate that will offer to the largest banks the terms and conditions that are competitive with those obtained by smaller banks. Because of the ample capital capacity of the cross-guarantee marketplace, it will not be necessary, and in fact it will be extremely bad public policy, to force banks to participate in a guarantor syndicate on an "assigned risk" basis. Thus, banks will have the unrestricted right to pick and choose among the guarantor risks that they will accept and the terms and conditions under which they will accept those risks. At some premium rate, it will be possible to syndicate the cross-guarantee contract of any genuinely solvent bank in the cross-guarantee marketplace. This ability to syndicate will hold true no matter how big or how small the bank is.

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[32] Figure represents author's estimate of bank and S&L holding companies plus commercial banks, savings banks, and S&Ls outside of holding companies.

The pool of equity capital available to support 100% cross-guarantees could be expanded enormously if nonbank firms such as insurance companies and manufacturers became bank guarantors. Permitting nonbank firms to serve as guarantors would help to ensure an adequate pool of equity capital to underpin the 100% cross-guarantee contracts of the nation's largest banks. Nonbank firms would be parties to cross-guarantee contracts on the same terms and conditions as a guarantor bank. However, to protect the invincibility of the solvency safety net, a nonbank guarantor would have to have stop-loss protection for the guarantor obligations it assumed; its other liabilities would remain unguaranteed. Thus, if a nonbank guarantor filed for either Chapter 11 or Chapter 7 bankruptcy, its guarantor obligations, and only its guarantor obligations, would automatically be assumed by the providers of the bankrupt firm's stop-loss insurance.

Monitoring guaranteed banks

The guarantors' syndicate agent will continuously monitor the condition of the guaranteed bank on behalf of the guarantors. The actual on-site monitoring work will be conducted by employees of the syndicate agent or, alternatively, the syndicate agent might contract this work to a third party. This monitoring process is discussed in more detail starting at page ___ of the accompanying Appendix that describes risk-sensitive pricing for 100% cross-guarantees.

Employees of the guarantor banks will not be allowed to do any monitoring work. This prohibition will ensure that guarantors will not obtain information that could be used to the competitive disadvantage of the guaranteed bank. This prohibition also should eliminate any antitrust concerns about the 100% cross-guarantee concept.

The ability of a syndicate agent to attract guarantors to syndicates that it is attempting to organize will partially be a function of how well the agent has monitored the risks undertaken by its existing syndicates. Thus, the monitoring process will be subject to the competitive pressures to innovate and to do better, as will the other aspects of the cross-guarantee process.

The syndicate agent's monitoring work will completely replace the periodic examinations now conducted by government examiners. Since cross-guarantees will, as a practical matter, eliminate taxpayer risk in protecting depositors, government personnel will no longer need to periodically examine every bank and otherwise attempt to micro-manage the bank.

Cross-guarantee regulation

The enabling legislation for 100% cross-guarantees should designate the FDIC as the cross-guarantee regulator. The Federal

Reserve System should not serve as the cross-guarantee regulator because of the conflict of interest that will arise if the Fed is both the cross-guarantee regulator and the government lender of last resort. The Comptroller of the Currency also should not serve as the cross-guarantee regulator because that role will conflict with the Comptroller's chartering and other regulatory duties.

A key responsibility of the FDIC will be to review and sign all cross-guarantee contracts. Thus, 100% cross-guarantee contracts will not be valid without the FDIC's signature. This requirement will enable the FDIC to protect taxpayers by reviewing the capital adequacy and risk diversification of individual cross-guarantee contracts _before_ they become effective. This review will be key to maintaining the public's and the taxpayer's confidence in the soundness of the entire cross-guarantee mechanism.

The FDIC must not be empowered to review the appropriateness of the pricing formula or other provisions of cross-guarantee contracts. These contractual provisions must be the sole province of the guaranteed bank and its guarantors if the deregulation intent of 100% cross-guarantees is to take hold.

The FDIC, however, will have to spot-check the market value net worth of guarantor banks to determine that the aggregate market value net worth of all the guarantor banks is being estimated properly. This spot-checking, akin to Internal Revenue Service tax audits, should be much less extensive than the traditional safety-and-soundness examinations conducted by bank examiners.

The FDIC's oversight of cross-guarantees should be financed by a modest fee. This fee could be collected by the syndicate agents and forwarded to the FDIC. A fee equal to .1 basis point on total assets of all guaranteed banks will raise $45 million annually in 1989 dollars. This sum will permit the FDIC to assign a more-than-adequate staff of 500 to regulate the cross-guarantee process.

Likewise, bank chartering agencies, such as the Comptroller of the Currency, the Office of Thrift Supervision, and state banking departments will not have to be concerned about the activities or capital levels of individual banks protected by cross-guarantees. However, federal and state chartering agencies will continue to enforce other types of regulation that apply equally to all types of businesses, such as environmental, employment discrimination, and truth-in-lending laws.

The loss prevention features of 100% cross-guarantees at work

Guarantor losses will be very low because the loss prevention features of 100% cross-guarantees reflect this simple fact: Bank failures are not random events that suddenly happen without any forewarning. Even in the worst of times, banks fail over time; furthermore, most bank failures, like most business failures, can be averted through corrective action applied in a timely manner. The ability to prevent failure is especially true of larger banks. Three loss prevention devices, each of which was summarized above, are discussed below.

Risk-sensitive premiums will discourage bad banking

Risk-sensitive premiums will discourage mismanagement and unjustifiable risk-taking by bank managements because potentially unrewarding risk-taking will be penalized sufficiently to make it most uninviting. This response will reflect the risk-moderating virtue of risk-sensitive premiums. As a result, banks will make fewer loans and investments that eventually will sour; bank failures and near failures, consequently, will decline sharply. The accompanying Appendix describes the likely mechanics of risk-sensitive pricing.

The present flat-rate federal deposit insurance premium does not penalize bankers for taking undercompensated risks or for otherwise mismanaging their institution. In effect, the flat-rate federal deposit insurance premium encourages risky banking by not discouraging it. Box 10 describes the two actuarial shortcomings of federal deposit insurance, one of which is the flat-rate deposit insurance premium.

At the margin (i.e., on a transaction-by-transaction basis), if a bank has undertaken an inadequately compensated risk, cross-guarantees will be more expensive for the bank than the risk-adjusted return that the bank can expect to earn on that risk. Thus, an individual loan or investment that a bank makes will pay off for the bank's stockholders only if that loan or investment realistically offers a return that is higher than the cost of the cross-guarantee premium associated with that loan or investment.

Management will routinely make these cost/benefit assessments because the risk-sensitive pricing formula will be set out in the bank's cross-guarantee contract. Such an assessment is irrelevant today because the flat-rate federal deposit insurance premium does not vary with the risks taken. In effect, bank managers today see only the benefits of making a risky loan or investment but not the associated deposit insurance cost.

Rational bank managers will respond to adverse cost/benefit assessments by not making loans and investments that offer an insufficient risk-adjusted yield.[33] Rational managers will make sure the yield will cover the cost of the bank's cross-guarantees and will provide an adequate return on its equity capital. An irrational bank manager, however, will eventually lose his or her job when subsequent losses force corrective changes in his or her bank.

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[33] A risk-adjusted yield is the anticipated interest rate or yield on a loan or investment reduced by a realistic expectation of the loss in value that can be expected for that type of loan or investment. Take, for example, a loan that has a stated interest rate of 12% and that is of a type where a 2% loss rate can reasonably be expected. That loan has a risk-adjusted yield of 10%.

The risk-sensitive premium rate will be recalculated frequently, perhaps as often as weekly or biweekly for larger banks. Thus, a bank's premium rate will rise on a real-time basis as the riskiness of its assets climbs relative to the market value of its own on-balance-sheet equity capital. This frequent repricing will enable a bank's top management and its board of directors to monitor the aggregate change in the bank's riskiness, as measured by the cross-guarantee formula. Like other features of 100% cross-guarantees, the marketplace will determine pricing frequency.

The risk-sensitive premium paid directly by a guaranteed bank to its guarantors will be the option price that it pays in exchange for a legally enforceable option on the equity capital of its guarantor banks. See Box 7 for the characterization of an insurance contract as an option agreement. Thus, equity capital will be available immediately and unconditionally to protect the depositors and other creditors of a guaranteed bank should its own on-balance-sheet equity capital be wiped out by losses.

The guaranteed bank's own equity capital will effectively serve as the insurance deductible under the cross-guarantee contract. That is, the guaranteed bank's own equity capital will absorb the first dollars of any loss it suffers. This loss could be an operating loss or a decline in the value of the bank's assets. Only after this deductible is exhausted will losses then be incurred by the insurer -- in this case, the first-tier guarantors.

As is also the case with insurance policy deductibles, the premium rate for the 100% cross-guarantee will vary inversely with the amount of the guaranteed bank's own on-balance-sheet equity capital. The larger the deductible or on-balance-sheet equity capital amount, the lower the insurance or cross-guarantee premium rate.

The premium rate for a bank's cross-guarantees will be a very sensitive barometer of the guaranteed bank's future financial health. A rising premium rate will evidence the increasing probability that the guarantors' earnings and equity capital will be drawn upon eventually to protect the principal and liquidity of the guaranteed bank's deposits and possibly its other liabilities. In effect, the guaranteed bank will pay an increasingly higher price for its option to drawn upon the earnings and, if necessary, the equity capital of its guarantors.

Guarantors will have a powerful incentive -- minimizing their losses--to develop sophisticated techniques for measuring banking risk. This development work will build on and parallel the risk-assessment and pricing techniques developed over the last decade for analyzing and securitizing financial assets.

The author's research indicates that the premium rate for 100% cross-guarantees probably will range initially from a likely minimum of 2 basis points per dollar of protected liabilities for sound, adequately capitalized banks to a high of 70 or 80 basis points for very risky banks on the verge of being taken over by their guarantors.[36] This premium rate will be in addition to the monitoring fee that the syndicate agent will collect to cover its monitoring costs. The range of possible premium rates is illustrated in Exhibit 6, which follows page 26.

Cross-guarantee contracts most likely will require a bank to periodically tell its shareholders what its cross-guarantee rate premium currently is. The purpose of this disclosure will be to stimulate equity capital discipline by the guaranteed bank's stockholders. Stockholders almost certainly will express extreme discontent with the bank's management over a high cross-guarantee premium rate that depresses the bank's earnings and stock price. This type of discipline, emanating from existing stockholders, will be far more effective than depositor or regulator discipline. Depositors are unlikely to react to the disclosure of a high premium rate for their bank because they will know that they will be protected from any loss no matter what happens to the bank.

In most banks, a rising premium rate will eventually stimulate corrective action within the guaranteed bank, an action that will bring the premium rate back down. This corrective action will fall into one or both of the following broad categories: The bank's management will improve the bank's performance, in part by reducing the riskiness of its assets and/or the bank will voluntarily raise additional equity capital.

Bringing new capital into the bank will reduce the probability that the earnings or the equity capital of the bank's guarantors will be drawn upon to protect the bank's depositors. This lower probability will translate into a lower cross-guarantee premium rate because the newly invested capital will effectively increase the guaranteed bank's cross-guarantee deductible. The injection of new capital almost certainly will dilute the ownership interest of existing stockholders as the new investors will want a sufficient number of shares of stock in the bank to claim the bulk of the cross-guarantee premium savings that their investment will foster. Additionally, the new investors almost certainly will insist on managerial changes that will protect the newly invested capital from future losses.

The potential for achieving these savings will enable even a barely solvent bank to attract fresh equity capital, provided the bank will have adequate earnings after the capital injection to pay an acceptable return on the newly invested capital. Existing stockholders will still benefit if the price-earnings ratio of the bank's stock rises because fresh capital is invested in the bank. Bank 2 (the middle bank) in Exhibit 5 (follows page 25) illustrates this dynamic.

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[36] The computer simulation underlying this conclusion is available from the author upon request.

Equity Market Intervention

If the management and directors of the bank fail to reverse a rising premium rate, then the bank's stock price will drop even more. At some point, this price decline will trigger "equity market intervention." That is, a stock price decline driven by the rising cost of a bank's cross-guarantees will trigger marketplace intervention in the bank's affairs to correct the causes of the rising premium. In almost all circumstances, equity market intervention will pull the bank out of its nosedive toward insolvency before it actually becomes insolvent.

Intervention will occur for the following reason: A rising cross-guarantee premium rate will depress the guaranteed bank's stock price as both its earnings and the price-to-earnings ratio of its stock declines. If we assume there is a constant price-to-earnings ratio, the bank's stock price will decline proportionally as a rising premium rate reduces the bank's earnings. However, the rising rate will signal a growing probability that the guaranteed bank will become insolvent. The growing probability of insolvency will begin to depress the bank's price-to-earnings' ratio, particularly as the premium rate rises above 15 or 20 basis points.

Thus, a rising premium rate, coupled with a declining price-to-earnings ratio, will cause the bank's stock price to decline more sharply than just the drop in its earnings. A rapidly declining stock price will cause some type of marketplace intervention in the bank's affairs to occur. The bank's directors, fearful of stockholder lawsuits, might replace the bank's top management. If the directors refuse to act or new management does not correct the bank's problems, then the existing stockholders might begin a proxy fight to wrest control of the bank from its existing directors and management. Alternatively, a corporate raider might launch a hostile takeover attempt on the bank. Hostile takeovers will occur because a successful takeover potentially will be very profitable if the takeover is followed by improved management and/or a recapitalization of the bank.

Improved management, coupled with newly invested capital, will greatly reduce the probability that the bank will fail. A lower probability of failure will translate into a lower cross-guarantee premium rate. These factors will cause both the bank's earnings and the price/earnings multiple of its stock to rise substantially. This price rise will bring great stock price appreciation to those investors who participate in the hostile takeover.

Since all large banks (those with assets of more than $1 billion) and many mid-size banks have publicly traded common stock, equity market intervention should become a much more powerful disciplining force on bank managers than it is today.

Equity market invention will not work for mutual banks, for banks with limited public ownership, or for the American subsidiary bank of a foreign-domiciled bank. Consequently, these types of institutions may have to pay a higher premium rate for their cross-guarantees to compensate for the absence of potential equity market intervention should the institution start a downhill slide.

Guarantor takeover of a failing bank

If equity market intervention fails to work or does not act quickly enough, guarantors almost certainly will take over the failing bank before it actually becomes insolvent. This takeover most likely will be executed under one of the negative covenants incorporated in the cross-guarantee contract. Box 11 summarizes the likely terms and conditions of the typical 100% cross-guarantee contract. The takeover will not require the prior or subsequent approval of the FDIC. This feature underscores one of the key advantages of 100% cross-guarantees over federal deposit insurance: prompt closure of failing banks before they become insolvent.

Once guarantors take over a failing bank, they most likely will try to sell it as a going concern in order to fully realize its marketplace franchise value. Only rarely will guarantors pay off the depositors and other protected creditors of a failed bank and liquidate its assets in a receivership or in a Chapter 11 proceeding under the Bankruptcy Code. In a liquidation, the guarantor obligations of the failed bank will then become the direct obligation of the bank's guarantors.

As in any type of foreclosure action, the guarantors will have to deal with the guaranteed bank in a manner that will minimize the losses of the failed bank's stockholders. The enabling legislation for 100% cross-guarantees should provide that the stockholders of the guaranteed bank can sue to recover any such damages from the bank's guarantors.

The FDIC should be empowered to force a syndicate of guarantors to take over or close any bank that a syndicate has guaranteed if the FDIC had good, supportable reasons to believe that the bank is insolvent. This power would give both the community of guarantors and the taxpayer the assurance that a syndicate will not unwisely permit a guaranteed bank to stay open too long. Thus, while the FDIC could not block a guarantor takeover of a bank, it should be able to force a takeover.

On rare occasions, guarantors will suffer losses because the negative covenants do not permit a takeover before the guaranteed bank becomes insolvent or the guarantors fail to act in a timely manner once a negative covenant becomes operative. However, it is readily conceivable that a year or even longer could pass in which there will be no guarantor losses in the United States because of the following: the risk-deterring nature of the risk-sensitive premium, the corrective actions stirred by equity market intervention, and the guarantor takeovers of failing banks before those banks reach insolvency.

Chapter 6

Seven Safeguards Built Into 100% Cross-Guarantees

Seven different safeguards have been incorporated in the 100% cross-guarantee concept; each will be discussed below. Working together, these safeguards will permit both the banking system and the ongoing risk syndication process to work smoothly and efficiently while providing depositors, public officials, taxpayers, and the rest of the world with unsurpassed confidence that the American banking system will operate without hesitation or depositor losses, even during times of enormous economic and financial stress.

Safeguard 1.

Guarantors must be guaranteed with regard to their cross-guarantee obligations. It is crucial to the soundness of the cross-guarantee concept that every guaranteed bank itself be a guaranteed bank. This requirement will protect the integrity of the 100% cross-guarantee concept by ensuring that no bank will ever fail to meet its obligations as a guarantor. Every nonbank guarantor also must be similarly guaranteed as to its guarantor obligations. This mandatory back-stop requirement is the only way that the stop-loss provision (described below and in Box 12) can assure the American taxpayer that no guarantor bank will ever fall through the solvency safety net. Cross-guarantee regulations also must require that guarantors assume only very small portions of each cross-guarantee risk, whether the risk of one large bank or a pool of smaller banks (see Boxes 9, 13 and 14).

Safeguard 2.

Base equity capital requirement for the banking system. Base equity capital is a concept unique to the 100% cross-guarantee concept. The purpose of base equity is to maintain within the banking system enough equity capital so that the system will survive a massive round of bank insolvency losses -- even worse than the Great Depression -- and still have sufficient equity capital remaining on which to rebuild the banking system without any taxpayer assistance.

Base equity capital is the bottom-most portion of the equity capital invested in the banking system. This capital will be unavailable for cross-guarantee risk-taking; however, it will not be legally or physically separated from the rest of the equity capital in individual banks. In effect, an individual bank will undertake cross-guarantee risks only by risking that portion of its equity capital in excess of the banking system's base equity capital requirement. Box 13 describes in detail how base equity capital will be calculated for the banking system and then for individual banks.

Safeguard 3.

Risk-diversification requirements imposed on guarantor banks. Two-risk-diversification requirements will be imposed on banks acting as guarantors, each of which is described in more detail in Box 14.

In brief, no bank will be permitted to contract to receive projected annual premium (PAP) income as a guarantor that totals more than 5% of the bank's excess equity capital. The rationale for this 5% limit is set out in Box 14. This capitalization requirement for the cross-guaranteeing activities of a bank is more than 50 times as conservative as the capitalization practices of American property and casualty insurance companies, many of whom assume liability insurance risks that are far more unpredictable than bank insolvency.

Also, no bank will be permitted to contract with any one bank to receive PAP that exceeds 5% of the total amount of PAP that the bank could contract to receive. Thus, a bank will have to guarantee at least 20 other banks if it contracts to receive the maximum allowable amount of PAP.

Safeguard 4.

Risk diversification requirements for any one cross-guarantee contract. Two risk-diversification requirements will be imposed on every cross-guarantee contract, both of which are described in Box 15. These requirements will serve to widely distribute cross-guarantee risks so that there will be an extremely low probability that any one insolvency loss will activate a guarantor's stop-loss protection. In brief, each guaranteed bank will have to have a minimum number of guarantors, with a larger number of guarantors required for larger banks. Further, each guarantor will be limited to assuming just a small percentage of any one cross-guarantee risk.

Box 15 also describes an additional requirement for the cross-guarantees of smaller banks that will prevent the "closed-loop" phenomenon: A group of small banks will join to cross-guarantee each other in an undiversified manner that consequently contains all or most of the risk of failure within this group of banks. The closed-loop phenomenon will not be a problem with larger banks, because the 100% cross-guarantee risks for these banks will be spread widely enough to prevent a closed-loop from developing.

Collectively, these risk-diversification rules will act to hold excess equity capital in the guarantor banks even though actual insolvency loss experience might justify a lower level of excess equity capital within the banking system. The FDIC will be charged with making sure that these diversification requirements are met when cross-guarantee contracts are signed or amended.

Safeguard 5.

The "stop-loss" feature of 100% cross-guarantees. The stop-loss feature, which must be mandatory in all cross-guarantee contracts, is perhaps the most important safeguard for 100% cross-guarantees: Stop-loss is the device by which very large insolvency losses will be spread widely, but thinly, across the equity capital base of the entire banking system. The stop-loss feature is described in greater detail in Box 12. Exhibit 2 (following page 8) illustrates how very large insolvency losses will flow from tier to tier of guarantor banks until they have been fully and safely absorbed within the banking system.

Because of the risk-diversification rules described above, the stop-loss feature will be invoked very rarely. Several years could pass in which no loses were passed on to even second-tier guarantors. If we assume that a bank could pass on to its guarantors only those losses that exceeded five times its maximum permissible PAP income and if we further assume that a bank could not receive more than 5% of its PAP from any one guaranteed bank, then the stop-loss feature will not be activated for any one bank failure unless the loss percentage in the failed bank exceeds 100 times the premium rate it was paying at the time its PAP was calculated. This figure equates to an insolvency loss equal to 200 times the initial expected loss in the failed bank. These multiples signify a rate of decline in the failed bank that will seldom occur. Thus, it is more likely that losses will flow through a guarantor bank to its guarantors only if the guarantor suffers several failures in quick succession and if these failures are quite costly relative to the premium rate that was being charged to the failed banks.

Safeguard 6.

The FDIC Backup Fund. With the advent of 100% cross-guarantees, the BIF would be succeeded by the FDIC Backup Fund. Specifically, the government securities in which the BIF's $13 billion of reserves are now invested would be transferred into the Backup Fund where they would continue to compound, according to government accounting practices.

The Backup Fund would be drawn upon to cover bank insolvency losses in only two very rare circumstances. The first would occur in the aftermath of an enormous economic catastrophe that is particularly damaging to banks. However, as discussed above, the ability of the federal government to deliver on all of its obligations, including its deposit insurance commitment, in such a circumstance is highly questionable. In effect, if the solvency safety net of the banking system fails, the Backup Fund may not be able to deliver either.

The second circumstance would arise if the FDIC permitted a "closed-loop" situation to develop and if subsequent bank failures among this closed-loop of banks exhausted the combined equity capital of these banks. This situation would be comparable to what occurred when the Butcher banks failed in early 1983. Such an event could occur only because of regulatory negligence. It would be appropriate in such a circumstance that the FDIC Backup Fund, and thus the taxpayer, pay for these losses.

Safeguard 7.

Bank run protection. Providing unlimited amounts of liquidity to a bank experiencing a run is the only effective way to stop a bank run. Like pouring water on a wood fire, pumping plenty of cash into a bank experiencing a panic-driven run will quickly squelch that run. The emergency liquidity injected into a bank will let its nervous depositors protect their wealth by pulling their money out of the bank in accordance with the original terms of their deposit contract. As explained in Box 1, this unrestricted honoring of the original terms of all deposit contracts is the essence of maintaining depositor and public confidence in any deposit insurance program. The bank run issue is addressed in greater detail in Box 16.

Protecting every dollar of deposit, as 100% cross-guarantees will do, will as a practical matter eliminate bank runs. Nonetheless, it is absolutely essential to the credibility and soundness of the 100% cross-guarantee concept that provision be made to provide unlimited liquidity to guaranteed banks whenever the need for it arises.

Because of the extensive equity capital resources of the banking system, it is unlikely that the Federal Reserve will ever have to supply emergency liquidity to the banking system once cross-guarantees became fully effective. The banking system will be able to manufacture whatever liquidity it needs on its own. Reducing this burden on the Fed will permit the Fed to concentrate on its monetary management activities without having to worry about the sometimes conflicting objectives of a lender of last resort and of a monetary manager.

Chapter 7

The Transition to 100% Cross-Guarantees

The transition to 100% cross-guarantees should not be difficult. Banks should be permitted by the appropriate enabling legislation to obtain 100% cross-guarantees beginning one year after the enactment of the cross-guarantee legislation. This date will be known as the "opt-in" date because switching to cross-guarantees will enable a bank to opt into 100% cross-guarantees and thereby escape all safety-and-soundness regulation that now exists to protect the federal deposit insurance funds. One section of the enabling legislation should clearly specify the existing banking laws that will not be applicable to banks protected by cross-guarantees.

The one-year period preceding the opt-in date will allow sufficient time for syndicate agents to establish themselves and to start organizing cross-guarantee syndicates for those banks that clearly will be able to obtain cross-guarantees as of the opt-in date. A sufficient number of banks should be able to obtain cross-guarantees by the opt-in date to give the cross-guarantee marketplace sufficient critical mass to immediately make 100% cross-guarantees a successful protective device. Permitting nonbanks to act as guarantors will further ensure that a critical mass of capital will be available on the opt-in date for guaranteeing banks.

Most banks will switch to 100% cross-guarantees as quickly as they can because they will gain freedom from burdensome government regulation while obtaining full, explicit coverage of all deposits liabilities at a fraction of the cost of federal deposit insurance.

Once a bank becomes a guaranteed institution, it should never again be allowed to operate without 100% cross-guarantees. This requirement must be an ironclad provision of the enabling legislation creating the 100% cross-guarantee concept.

Every bank should be required within three to five years after enactment of the enabling legislation to obtain a 100% cross-guarantee of its deposit liabilities. A bank that cannot obtain a 100% cross-guarantee by the end of that period effectively will be insolvent or will be in such marginal condition that the FDIC will have to liquidate or merge that bank out of existence. Liquidation or merger should, therefore, be the fate of every bank that cannot obtain 100% cross-guarantees within a reasonable period of time.

It is vitally important from the taxpayers' perspective that the federal government does not become a deposit insurer of last resort for banks that cannot obtain 100% cross-guarantees within the three- to five-year period. Banks that cannot obtain 100% cross-guarantees will be undercapitalized institutions whose deposits will be very expensive for the federal government to insure and thus very expensive for the taxpayer. No valid public policy purpose will be served by keeping these institutions alive at taxpayers' expense. Perpetuating a direct deposit insurance role for the federal government also will be harmful to the banks that opt into 100% cross-guarantees.

Because 100% cross-guarantees will use private sector personnel to syndicate and monitor 100% cross-guarantee risks, the jobs of as many as 20,000 federal and state employees now engaged in traditional bank examination, supervision, and liquidation work will end.[35] Generous severance pay, job placement, and relocation allowances should be offered to these employees to assist their transfer to the private sector. A one-time "exit fee" equal to 2 basis points of deposits and paid by banks as they opt for 100% cross-guarantees will generate $700 million, on the basis of total deposits in banks today. This amount, equal to at least $35,000 per displaced employee, will provide an average of six months of severance pay plus job placement and relocation assistance to the displaced employees. Most of these skilled employees will quickly find new employment in the private sector, possibly even with syndicate agents.

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[35] Federal and state bank and S&L supervisory agencies currently have about 24,000 employees engaged in all aspects of bank and S&L examination and supervision and in the liquidation of failed institutions. This figure is based on data collected by the author from federal agencies and the Conference of State Bank Supervisors. These agencies would need no more than a few thousand employees once 100% cross-guarantees are fully implemented.

Chapter 8

Conclusion

The steadily worsening travails of federal deposit insurance have occurred against the backdrop of enormous budget deficits and the decline of America as a world power, economically and politically. America faces the prospect of continuing erosion in both the domestic and international competitiveness of American-domiciled banks. The increasingly heavy hand of regulation and the deleterious effect of the cross-subsidies inherent in flat-rate deposit insurance premiums have caused the decline of American banking.

The continuing debate over bank powers also is increasingly a deposit insurance reform issue because most limitations of bank powers are couched in terms of protecting SAIF and BIF. Thus, deposit insurance reform is much more than just a banking issue. It also is the broader issue of unleashing the pent-up potential of the banking system by permitting marketplace forces to more efficiently protect depositors as the declining efficacy of government regulation becomes more pronounced.

The need for 100% cross-guarantees is more acute in America than in other industrialized nations because deposit insurance and banking regulation have caused greater distortions and inefficiencies in American banks than in other banking systems. However, the banking systems of other nations also will benefit if they implement the 100% cross-guarantee concept. Thus, the race is on. Will America win by becoming the first nation to implement 100% cross-guarantees? Or will other nations capture the lead and further trounce U.S. banks until America finally adopts cross-guarantees?

Box 1

Guaranteed liquidity: The essence of all sound deposit insurance programs

Guaranteeing the liquidity of a deposit is a generally unrecognized, yet essential, element of any sound deposit insurance program. Guaranteeing the liquidity of a deposit simply means that the depositor will be able to withdraw his or her funds from a bank under the original terms of his or her deposit contract. For checking and passbook accounts, this guarantee means withdrawal upon demand. For certificates of deposit (CDs), it means withdrawal when the certificate matures or when it is presented for early withdrawal, if that option is permitted under the certificate's original terms.

Providing liquidity to depositors (i.e., permitting them to withdraw their deposits) automatically protects their principal and accrued interest. Once a depositor has pulled his or her money out of the bank, he or she can no longer be affected by what happens to that bank. This point may seem self-evident, but it is key to understanding why an unimpeachable guarantee of unrestricted liquidity for depositors is essential to establishing and maintaining the creditability and soundness of any genuine depositor protection mechanism.

The quasi-state deposit insurance schemes in Ohio and Maryland for state-chartered S&Ls collapsed in 1985 after a few large, insolvent S&Ls failed. The other S&Ls that were insured by these schemes quickly closed their doors because they could not obtain sufficient liquidity to permit their panicky depositors to withdraw their funds at will or under the terms of their CDs. Even though these depositors eventually will get their money back (their principal will be protected), they are illiquid in the meantime (the original terms of their deposit contracts were not honored).

Box 2

Depositor discipline:
An ineffective alternative to 100% cross-guarantees

The concept of depositor discipline is often touted as a viable substitute for the inability of regulators to turn around a failing bank or to force fresh equity capital investment in it. However, depositor discipline, if really allowed to work, is largely ineffective and hazardous to the economy for two reasons: (1) Bank deposits, unlike bank stock, represent very risk-averse investments to their owners, and (2) the tools of depositor discipline are crude and potentially counterproductive.

The risk-averse nature of bank deposits

Bank deposits are not speculative investments even when owned by people prone to making very risky investments. People hold bank deposits to meet a felt need for liquidity and/or a high safety of principal. The liquidity and safety sought in bank deposits holds true whether the person is highly risk averse or is very risk prone. In effect, a person's attitude toward the riskiness of his or her bank deposit is independent of that person's overall risk preference. For example, a wealthy individual speculating in junk bonds will be much more risk averse about his or her bank investment than the junk bond investment. In fact, depositors represent the least appropriate discipliner of banks because they are so risk averse with regard to their bank deposits. Depositors generally are not in the business of assessing risk. They are not geared to monitor banking risk; consequently, they tend to panic when problems erupt.[36]

Depositor discipline: Crude and counterproductive

Depositor discipline can take one of two forms. In its milder form, depositors will ask for higher interest rates to compensate for a higher, but still slight, probability that the bank will fail and leave the depositor momentarily illiquid and possibly poorer. But a higher rate of interest cannot begin to compensate for losing liquidity and, perhaps, a major portion of the deposit. Weak or insolvent banks may willingly pay higher deposit interest rates simply to get the funds with which to take even bigger gambles in the hope of large profits. However, this form of rainbow chasing usually leads to even higher insolvency losses when the bank finally is taken over.

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[36] The herd effect of uninsured depositors in a troubled bank is captured effectively by Alan E. Grunewald and Alex J. Pollock, "Money Managers and Bank Liquidity," Proceedings of the 1985 Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, pages 563-75.

Thus, if the likelihood of failure becomes more than slight, then the second form of depositor discipline will come into play: the bank run. If the run becomes contagious, the result can be a regional or national banking panic.

The underlying problem with depositor discipline is that depositors compete with each other to get their money out of the bank once fear spreads that their bank may really shut its doors. Those depositors who get their money out no longer are depositors and thus no longer care what happens to the bank. Those whose deposits are frozen in a closed bank are stuck; they can no longer exercise depositor discipline because they lose all bargaining power and withdrawal rights the minute the bank is closed.

Stockholders and guarantors of a bank

The owners of a bank are in an entirely different position. Unlike depositors, stockholders cannot withdraw their investment from the bank. However, they can use their voting power to oust directors or to discipline management in a proxy fight. They also can try to limit their loss by selling their stock to a third party. In this sense, stockholders, like depositors, are competing to get their money out first. Overall, though, bank stockholders have more tools than depositors to influence a bank's management future actions.

Guarantors of a bank's deposits, who in one sense are contingent stockholders of the bank, will have an even greater incentive than the bank's actual stockholders to influence the bank's direction. Unlike stockholders, guarantors will not be able to limit their losses by selling a stock position. Guarantors can limit their losses only by canceling the cross-guarantee contract in the hope that another syndicate will assume the bank's cross-guarantee risk. However, this all-or-nothing proposition is harder to execute than selling just a small portion of the bank's stock. Unlike depositors or stockholders, a bank's cross-guarantee syndicate could not run on itself or sell stock to itself. In effect, there can be no "me first" among the guarantors of a bank. They get into and out of the bank in unison.

Box 3

Risk-based capital:
A poor substitute for cross-guarantees

Risk-based capital standards, like all government capital standards, lack the crucial option-on-outside-capital feature of the 100% cross-guarantee contract. In fact, risk-based capital standards are nothing more than a measurement tool to determine if a bank has adequate capital. Like an oil pressure warning light on a car, government capital standards merely signal to a bank's regulators that a bank is running low on capital. Risk-based capital standards do not and never can provide the mechanism for automatically replacing the capital of a bank that the standards show to be undercapitalized. Instead, capital shortfalls are made up only after the fact and only if the bank raises more capital.

If a bank fails to raise its equity capital up to the level called for by the risk-based standards, then its regulators are forced to take legal action against the bank or to tolerate its capital deficiencies. Legal actions usually cannot force capital to be invested in a bank; they can try merely to contain the risk of insolvency present in an undercapitalized bank. Ultimately, the regulators may be forced to liquidate the bank or, as usually occurs, sell or merge it into a stronger institution.

The new risk-based capital standards offer little, if any, improvement over existing capital standards and may, in fact, be worse. The risk-based standards, which are to be fully phased in by 1992 under the Basle accord, deal only with credit risk. They ignore the interest rate, concentration, and foreign exchange risks found in most, if not all, banks.

The new standards largely treat private sector assets (except home mortgages) as if they had the same degree of credit risk. The uniform treatment of private sector risks perpetuates the failing of all government capital standards where one size must fit all. Banks are required to overcapitalize low-risk assets while being permitted to undercapitalize high-risk assets. As capital standards are effectively raised to compensate for the shortcomings of earlier standards, banks are caught in a vicious spiral in which rising capital standards encourage them to hold riskier and riskier assets in an attempt to maximize stockholder returns.

Box 4

How 100% cross-guarantees would have prevented the FSLIC fiasco

The bankruptcy of hundreds of S&Ls, which will cost the American taxpayer approximately $125 billion on a present value basis,[37] would never have occurred had America always had 100% cross-guarantees priced on a risk-sensitive basis. Risk-sensitive cross-guarantee pricing would have priced the traditional, maturity-mismatched S&L out of business decades ago. The traditional S&L mismatched the maturity of its assets by funding long-term, fixed-rate mortgages with short-term passbook savings. This borrow-short-to-lend-long philosophy invariably leads to financial disaster.

By 1960, risk-sensitive cross-guarantee premiums would have started rising for S&Ls that persisted in mismatching their asset and liability maturities. The need for this type of corrective pricing for cross-guarantees would have become painfully evident by 1966 at the latest when an increase that year in short-term interest rates (modest by recent experience) caused liquidity pressures in many S&Ls and pulled down the S&L industry's earnings by 21% from their 1965 level.[38] The 1966 run-up in short-term interest rates came on the heels of successively higher peaks in short-term interest rates in 1953, 1957, and 1959, as shown in Exhibit 9 (next page).

The federal government's response in 1966 was to extend the Federal Reserve's control over deposit interest rates (Regulation Q) to S&L deposit interest rates. Although this extension of Regulation Q was seen only as a short-term palliative, S&Ls became increasingly dependent on the below-market funding costs that Regulation Q fostered. The short-term benefits of Regulation Q enabled S&Ls to continue making long-term, fixed-rate home mortgages that, in turn, set the industry up for a massive wave of S&L insolvencies after the Fed stopped trying to control interest rates in October 1979. In effect, Regulation Q mistakenly attempted to preserve the fundamentally unsound financial structure of S&Ls.

Risk-sensitive premiums would have forced S&Ls by the 1960s to proceed in an entirely different direction because premium rates would have heavily penalized the borrow-short, lend-long financial structure of the traditional S&L. By the end of 1966, if not earlier, S&Ls would have responded in two ways to the higher cross-guarantee premiums they would have had to pay.

S&Ls would have begun to fund their fixed-rate mortgages with long-term, nonwithdrawable deposits and bonds, and/or they would have

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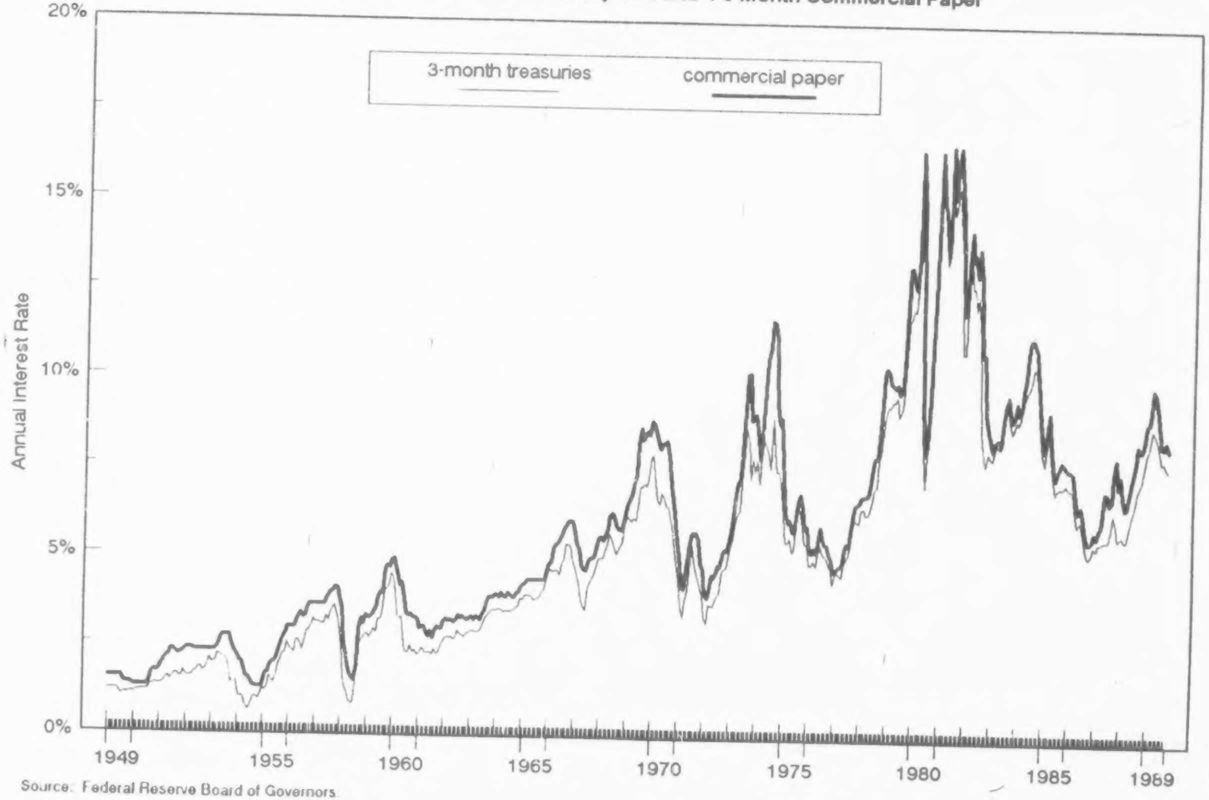
[37] Author's estimate.

[38] "Combined Financial Statements, FSLIC-insured Savings and Loan Associations, 1980," Federal Home Loan Bank Board, Washington, D.C., pages 4-5.

Exhibit 9

Interest Rate History

Monthly Averages of 3-Month Treasury Bills and 4-6 Month Commercial Paper



Source: Federal Reserve Board of Governors.

sold these mortgages in much greater quantities to pension funds, insurance companies, and other sources of genuine long-term funding.

S&Ls also would have become much more aggressive in promoting adjustable-rate mortgages that the S&Ls could safely fund with passbook savings and other types of deposits subject to frequent repricing. High risk-sensitive premiums caused by fixed-rate mortgages funded with short-term deposits also would have forced Congress to permit federally chartered S&Ls to offer adjustable-rate mortgages long before the Federal Home Loan Bank Board finally authorized them in 1981.

The even higher interest-rate peaks reached in 1969 and 1973-74 would have made guarantors of S&Ls even more nervous about maturity mismatching. This nervousness would have translated into even higher cross-guarantee premiums for severely mismatched S&Ls.

The response of guarantors of S&Ls in the 1960s and 1970s to increasingly higher interest rate peaks would have adequately prepared S&Ls for the seventh and worst post-World War II interest rate peak during the 1980-82 period. Instead, these record rates struck down the entire S&L industry.

By October 1979, when the Fed abandoned its increasingly ineffective effort to control interest rates, the maturities or repricing opportunities of S&L assets and liabilities would have been much more closely aligned in S&Ls protected by risk-sensitive cross-guarantees than was the case. Thus, when interest rates skyrocketed after October 1979, S&Ls would have been able to quickly pass through to mortgage holders the higher interest rates that S&Ls were having to pay on their deposits.

Rising home mortgage payments caused by S&Ls passing through higher interest rates would have caused some homebuyers to default on their mortgages. However, the rise in home prices that generally accompanied the inflation of the early 1980s would have protected S&Ls from serious foreclosure losses on these defaulted mortgages.

If any S&Ls came close to insolvency during these years, the guarantors would have quickly acted to have them taken over by stronger S&Ls or commercial banks. A stronger, but smaller, S&L industry would have emerged from this period. Instead, S&L regulators weakened capital standards and delayed closing many S&Ls that clearly were insolvent on the basis of the market value of their assets at that time.

Guarantors certainly would not have encouraged insolvent or nearly insolvent S&Ls to grow their way out of trouble after these S&Ls were drained of their equity capital by their losses in the early 1980s. The Texas experience is particularly distressing. As Exhibit 4 shows (following page 19), lending by Texas S&Ls exploded in 1983 on the downside of the Southwestern energy boom that peaked in 1980. Instead, risk-sensitive pricing would have forced these S&Ls to shrink so as to raise their capital ratios. Maintaining adequate levels of equity capital in these S&Ls would have prevented the massive insolvency losses that later occurred as crooked S&L officials plundered already insolvent S&Ls and as incompetent S&L

executives left Texas and numerous other states littered with half-built shopping centers and empty office buildings.

This anticipated response of guarantors to the S&L problems that have compounded over the last one-half century reflects this phenomenon: The commercial marketplace reacts much more quickly and honestly to changing conditions and to uncertainties than does the political process. Sometimes the marketplace will overreact for a, but that overreaction is far preferable to the greatly delayed reaction of a political process that often shelters economic losers at great cost to the taxpayers.

Box 5

Equity capital:
The substance of the solvency safety net

Equity capital represents the amount by which the value of the assets of a bank or any other type of business exceeds its liabilities. Equity capital has two components: (1) cash and property invested by stockholders in an enterprise, and (2) any earnings of the enterprise retained in the business.

Equity capital serves a dual purpose. First, equity capital, along with capital denominated as debt, finances the assets of an enterprise. In a bank, depositors account for the overwhelming portion of the debt capital used to finance the bank's assets.

Second and more importantly, though, equity capital absorbs the first dollars of loss experienced by any enterprise. These can be day-to-day operating losses or losses in asset value caused by external events. By absorbing the first dollars of loss, equity capital serves as a buffer or loss cushion to protect creditors or debt holders, such as depositors, from losses. In effect, equity capital gets wiped out before creditors suffer any losses. Exhibit 10 (see following page) illustrates this concept while contrasting the balance sheet of a typical bank with the balance sheet of a typical industrial corporation. Notice how much more highly leveraged the bank is.

The solvency safety net that underpins 100% cross-guarantees will be based on this key fact: American-domiciled banks and solvent S&Ls had $261 billion of stockholder or equity capital on September 30, 1989. Even if this capital were reduced by 25%, or $65 billion, to reflect unrecognized losses in bank and S&L assets, these institutions would still have had equity capital of $196 billion at the end of September 1989.

This capital was --

- Fifteen times the FDIC's likely reserves at the end of 1989.

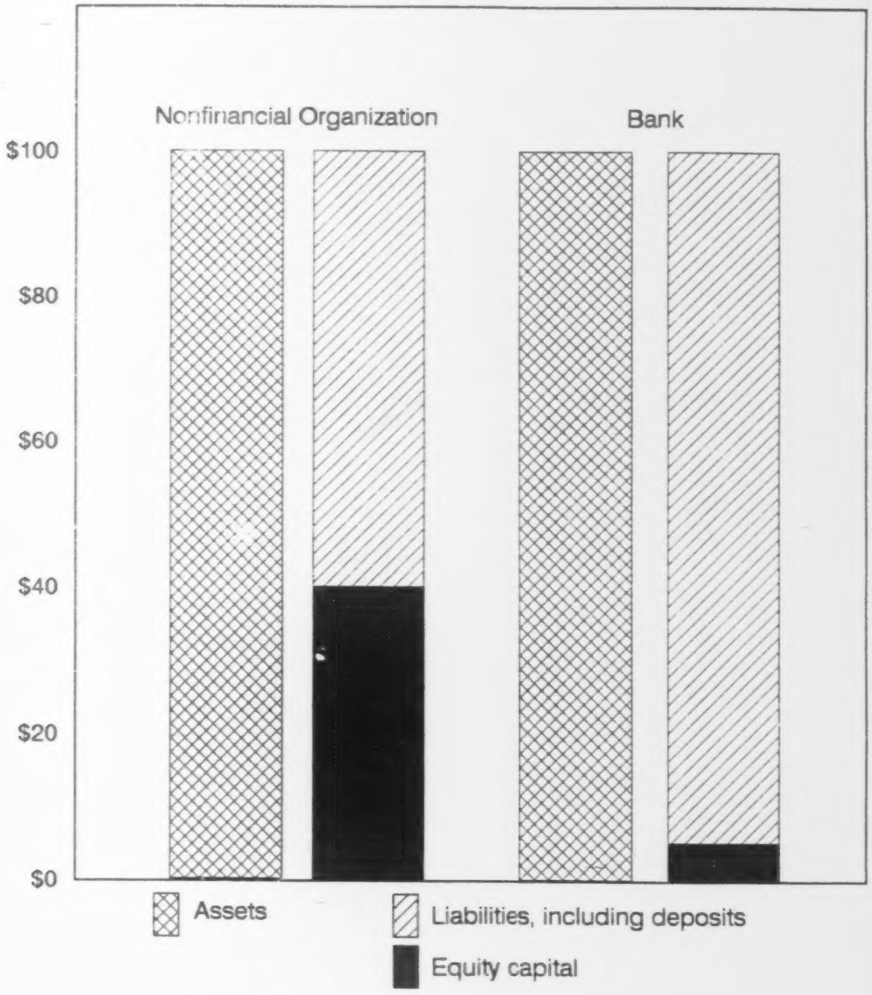
- One and one-half times the total "policyholders' surplus" of all American property and casualty insurance companies at the end of 1989. Policyholders' surplus is a conservative measure of equity capital invested in the insurance industry.

- Sixteen times the "confirmed means" of the members of Lloyd's of London at the end of 1988.

The private sector solvency safety net formed by 100% cross-guarantees will be vastly superior to a liquidity safety net provided by a government lender of last resort such as the Fed. A liquidity safety net is both illusory and incomplete. It is illusory

Exhibit 10

Comparison of Balance Sheet Structures:
Typical Nonfinancial Organization versus Bank



because a government lender of last resort risks taxpayer monies, not private sector equity capital, when it lends to a bank whose solvency cannot be readily determined. It is an inadequate safety net because emergency lending to a bank experiencing a run protects only those depositors who are fortunate enough to withdraw their deposits before the bank fails. In effect, a liquidity safety net addresses only the pseudo risk (illiquidity) in the depositor protection process, not the real risk, which is the absorption of bank insolvency losses.

Box 6

Bank equity capital always would have formed a solid solvency safety net under the American banking system

In every single year since the Civil War, the equity capital of the banking system has been sufficient to comfortably absorb bank insolvency losses in excess of current bank earnings. In particular, there was sufficient equity capital, at book value, in the commercial banks during the Great Depression to comfortably absorb the losses that depositors in failed banks suffered during the Great Depression. The following table illustrates what would have happened to bank equity capital had it absorbed all depositor losses during the Depression. Dollars are in millions.

Year	Reported bank equity capital (June 30)	Depositor losses	Equity less cumulative depositor losses	Reduced equity as % of bank assets (1)	Decline in equity as a % of 1930 equity
1929	$8,780	$ 85	$8,695	13.9%	n.a.
1930	9,318	264	8,969	14.1%	n.a.
1931	8,746	445	7,952	13.7%	- 6%
1932	7,484	190	6,500	14.3%	-20%
1933	6,190	650	4,556	11.7%	-34%
1934	6,625	7 (2)	4,984	11.5%	-29%
1935	6,601	3 (2)	4,957	10.5%	-29%
1936	6,703	3 (2)	5,056	9.4%	-28%

(1) The equity capital ratio (second column from the right) held surprisingly constant between 1929 and 1932 because total assets of commercial banks declined from $64.1 billion on June 30, 1930, to $46.3 billion June 30, 1932. Total assets dropped again to $40.6 billion by June 30, 1933, and then rose 37% to $55.6 billion by June 30, 1936, even as capital levels rose only 8% from 1933 to 1936.

(2) FDIC losses plus estimated losses to depositors in uninsured banks.

The bank insolvency losses of the 1930-33 period are highly unlikely to reoccur because the United States almost certainly will not return to a gold standard. The pre-1933 gold standard was the cause of the extreme price deflation of the 1930-33 period that largely caused 9,100 banks to fail.[39] This phenomenon is illustrated in Exhibit 8, which follows page 8. This price deflation also caused the substantial loan losses that in turn caused the nation's surviving banks to collectively experience net losses during the Great Depression.[40]

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[39] The author discussed the link between the gold standard and price deflation in "The Big Bust: The 1930-33 Banking Collapse -- Its Causes, Its Lessons." which appeared in The Financial Services Revolution: Policy Directions for the Future, Catherine England and Thomas Huertas, editors, Cato Institute, 1988, pages 41-67.

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[40] Ibid., page 65.

Box 7

The insurance contract:
An option on an insurer's equity capital

An insurance contract or policy is simply an option contract on an insurer's equity capital. By the same measure, an insurance premium is the price an insured pays to acquire that option. The insurance premium or option price varies directly with the insurance risk. That is, the insurer compensates for a greater risk or higher probability of loss by charging the insured a higher premium or option price for the right to draw on the insurer's equity capital. Like other option contracts, insurance policies expire on a certain date or upon the occurrence of a specified event.

An insured person exercises this option when the insured's equity capital declines because he or she has suffered a loss or injury. For example, if a person owns a house worth $100,000 that burns to the ground, that person's equity capital drops by $100,000. The $100,000 payment the homeowner receives from the insurance company restores his or her equity capital to its pre-fire level. However, the insurance company's equity capital is now $100,000 less. Over time, though, the insurance company will set its premium rates high enough to restore its equity capital to its original level, to cover its operating expenses, and to earn a profit on its equity capital.

Box 8

Lloyd's of London: Parallels with the 100% cross-guarantee concept

Lloyd's of London is the world's premier insurance market, in large part because Lloyd's insureds can expect payment on their claims with absolute certainty.[41] While Lloyd's experienced some governance and conflict-of-interest problems during the 1980s, it, nonetheless, remains an unquestionably sound source of insurance.[42]

Lloyd's is not a corporation with limited liability; as such, it has no capital of its own. Rather Lloyd's is a marketplace where insurance risks are assumed by individuals who risk their entire net worth or equity capital with every insurance risk they assume. It is the unlimited liability of Lloyd's members that gives Lloyd's insurance policies their certainty of payment. If a Lloyd's member cannot meet his or her Lloyd's obligations, then Lloyd's Central Fund assumes the member's unmet obligations.

Every risk insured at Lloyd's is spread among several of the 400 underwriting syndicates at Lloyd's, each of which may have up to several hundred members. The process for syndicating cross-guarantee risks is modeled after the risk syndication process that has operated successfully at Lloyd's for more than three centuries.

Lloyd's 28,500 members, or "names," diversify their risk exposure by joining 10, 15, or more syndicates. Many members of Lloyd's further reduce their risk by purchasing "stop-loss reinsurance." Stop-loss reinsurance, by absorbing all losses over a predetermined limit, has the effect of spreading the losses attributable to one member across a number of Lloyd's members.

The amount of premium income written annually on behalf of a Lloyd's member generally does not exceed one and one-half to two times that member's "confirmed means," or "show of wealth." The "show of wealth" of a Lloyd's member is that portion of his or her net worth that is relatively liquid and readily available to absorb losses. The amount of premium income that can be written or collected on behalf of an individual member in a calendar year cannot exceed three and one-third times the amount the member places on deposit at Lloyd's. This deposit is invested in marketable securities that continue to earn income for the Lloyd's member.

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[41] Information about Lloyd's can be found in many sources, including Lloyd's 1988 Global Report and Accounts; "Membership: The Issues," published annually by Lloyd's; Godfrey Hodgson, "Lloyd's of London: The Risky Business, Colorful History, and Turbulent Future of the World's Most Famous Insurance Group," New York, Viking Press, 1984; and Hugh Cockerell, "Lloyds of London: A Portrait," Homewood, Illinois, Dow-Jones Irwin, 1984.

[42] For a recitation of some of Lloyd's current problems, see "Risky Business: Lloyd's of London, An Insurance Bulwark, Is a Firm Under Siege," The Wall Street Journal, October 24, 1989, page 1.

Thus, the Lloyd's structure essentially permits its members' equity capital to do double duty. The member can invest his capital in relatively liquid income-producing assets while also being compensated for assuming the risks of a Lloyd's member. This same double duty for the equity capital of guarantors is an essential element to both the efficiency and the capital strength of the cross-guarantee concept.

Box 9

Syndicating the 100% cross-guarantee risk for smaller banks

Smaller banks most likely will be organized by syndicate agents into pools for syndication purposes. Smaller banks will generally be those with deposits and other protected liabilities under $500 million. A typical pool will be composed of smaller banks that are scattered across the country and that collectively may have total protected liabilities of $5 billion. Each bank in the pool will have its own cross-guarantee contract tailored to accommodate its unique risks and style of operation. However, cross-guarantee contracts for these smaller banks will not vary significantly because smaller banks generally have operations that are much less complex than those of larger banks. Guarantors, however, will guarantee the entire pool of banks. Thus, if one bank in the pool fails, the pool's guarantors will share the resulting losses, if any, in proportion to their share of the pool's overall risk that they previously had assumed.

Assuming a portion of the risk of a pool of cross-guarantee contracts will be comparable to buying mortgage-backed securities (MBS). MBS represent undivided interests in a group of mortgages that have been legally bundled into a package for financing purposes. The growth of MBS during the 1980s (more than $750 billion of MBS was outstanding at the end of 1989) suggests that it should be feasible to pool cross-guarantee contracts of small- and medium-size banks for syndication purposes.

Box 10

Federal deposit insurance: Its three actuarial shortcomings

Federal deposit insurance has three major and irreparable actuarial shortcomings.

1. Federal deposit insurance charges a flat-rate premium

Any actuarially sound insurance mechanism must charge a risk-sensitive premium. That is, the insurer must charge a higher premium rate to those insureds who are more likely to cause an insurance loss than the rate charged to less-risky insureds. In an actuarially sound insurance plan, the higher premium rate charged to the high-risk insureds should cover all of the losses and expenses associated with insuring that group of high-risk insureds. Risk-sensitive premiums also permit an insurer to vary its premium rate as the riskiness of an insured varies over time. Banks and S&Ls pay a flat-rate premium for their federal deposit insurance no matter how prudently or how recklessly they operate their institutions. In effect, the drunk drivers of the banking and S&L worlds pay no more for their deposit insurance than do their sober siblings.

FIRREA essentially has placed the BIF and the SAIF on a cost-plus pricing basis because the FDIC will be able to pass through higher losses by administratively raising the deposit insurance premium rate charged to banks. Theoretically, this increased rate will keep taxpayers ahead in their deposit insurance gamble; however, higher flat-rate premiums will increase the cross-subsidies and inefficiencies in federal deposit insurance that already are a growing burden on healthy banks, the banking system, and the entire economy.

2. Federal regulators do not promptly close federally insured banks

Any sound insurance mechanism must act aggressively to contain its losses. In deposit insurance, it is possible to hold total losses to almost zero if banks are closed as they approach insolvency. One of the hallmarks of federal deposit insurance, though, particularly in FSLIC, has the delayed closure of insolvent institutions.

Delayed closure often results from actual or perceived political interference in the closure process. Also regulators often anticipate that political interference will rear its head if they move too aggressively in closing banks before they clearly become insolvent. A clear indication of insolvency usually is not evident until months if not years after the bank actually became insolvent.

Regulators also lack the financial incentive to close insolvent institutions. Their compensation is not based on how well they do in minimizing bank insolvency losses nor are regulators fired if they daily in closing failed banks. In sum, regulators generally find it easier to delay closure rather than to aggressively pursue closure.

3. Federal deposit insurance is not properly capitalized

Any sound insurance mechanism must be properly capitalized. That is, it must have sufficient equity capital or net worth to absorb all of its insurance losses, even during catastrophic times.[43] Further, this capital must be real capital (i.e., it must be readily available to absorb losses).

Federal deposit insurance is highly flawed as an insurance mechanism because it does not have any genuine equity capital. The federal deposit insurance funds have no equity capital because they have been "on-budget" agencies of the federal government since 1969. That is the year in which the FDIC and FSLIC were placed on budget as part of a broader maneuver to mask the full budgetary impact of fighting the Vietnam WEar.

Since 1969, every premium dollar that the FDIC has collected has counted as a dollar of federal revenue, thus reducing the budget deficit by one dollar. Likewise, every dollar of FDIC (now BIF) expense has counted as a dollar of federal expenditure that adds to the annual budget deficit. Therefore, the losses of the federal deposit insurers, in excess of their current premium income, are borne by the taxpayer because these excess losses add to the federal budget deficit and thus to the national debt held by the general public. For the 1984-88 period, the FDIC's losses in excess of the premiums it collected added $9 billion to the national debt. The interest income the FDIC (now BIF) "earns" on its portfolio of government investments is phantom income for the government because for governmental accounting purposes this interest merely offsets interest expense paid by the Treasury.

For this reason, the FDIC's reserves at the end of 1989 of approximately $13 billion are an accounting fiction. One simple test will demonstrate this point. If Congress for some reason decided to pay out all of the BIF's reserves, the budget deficit would increase dollar-for-dollar for every dollar paid out. If the BIF really did exist as an entity apart from the U.S. Treasury, then the distribution of its reserves should have no budgetary effect whatsoever. In fact, any use of the BIF's reserves would add to the budget deficit because debt would have to be sold by the U.S. Treasury to the general public or abroad to raise the funds that BIF would spend in disbursing its reserves.

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[43] The author addressed the flaws in the capitalization of the FDIC in a written response to questions submitted to the author following his testimony on July 31, 1985, to the Committee on Banking, Housing, and Urban Affairs of the United States Senate. This response will be found on pages 1048-52 of Senate Hearings 99-406, Part I, on the subject of Deposit Insurance Reform and Related Supervisory Issues. These same capitalization flaws also were present in the FSLIC from its inception to its demise. They also are present in the new SAIF and BIF.

Box 11

Key provisions of the 100% cross-guarantee contract

A 100% cross-guarantee contract will function like any other type of insurance contract. Cross-guarantee contracts will address the following issues:

The term of the cross-guarantee contract

Three years is the likely term of a cross-guarantee contract; however, the actual contract term will be solely the province of the guaranteed bank and its guarantors. A shorter contract period will force excessively frequent contract negotiations; changing conditions within a bank and in the banking world eventually will invalidate longer-term contracts.

The scope of the guarantee

At a minimum, the cross-guarantee contract will fully protect all of the guaranteed bank's deposits and other cross-guarantee liabilities. Additional liabilities of the guaranteed bank will be covered at the option of the guaranteed bank and its guarantors. Protected liabilities also could include off-balance sheet commitments such as letters of credit; interest rate swaps, caps, and collars; foreign exchange swaps and futures contracts; and so forth.

Guarantors almost certainly will want the contract to cover all related banks, such as all the banks owned by a bank holding company. Thus, cross-guarantee contracts almost certainly will be executed at the holding company level. A holding company contract could protect both the deposits of subsidiary banks as well as other types of liabilities of the subsidiary banks, of nonbank subsidiaries, and of the holding company itself.

A holding company contract will enable the guarantors to protect themselves against asset shuffling among the banks owned by a holding company or a chain of banks comparable to the asset shuffling that occurred in the Butcher banks. These Tennessee institutions failed in 1983 after years of hiding asset-shuffling that fooled the bank examiners and allowed enormous losses to pile up in these banks. FIRREA contains a comparable cross-guarantee provision that ties together all banks that are under common ownership.

Guarantors also probably will prefer to guarantee a holding company in order to monitor closely the financial health of the entire firm and not just its subsidiary banks. Liabilities of a holding company protected under a cross-guarantee contract will earn an AAA credit rating just as will the deposits in its bank subsidiaries. This rating will enable the holding company to raise funds cheaply from many sources, and not just from deposits.

The formula for calculating the risk-sensitive cross-guarantee premium rate

Risk-sensitive pricing is discussed in the Appendix. The formula used to calculate the premium rate that will be paid to the bank's guarantors will be set out in the contract. The formula will be tailored to each guaranteed bank to reflect the breadth and complexity of its activities. This formula will be fairly simple for a small, community bank; it could be quite complex and extensive for a large, multinational bank. The premium formula will be the heart of the cross-guarantee contract; this portion of the contract will certainly be negotiated extensively.

Cross-guarantee contracts may specify a minimum premium rate. The author's research indicates that the minimum rate might be as low as 2 basis points (1 basis point equals .01%); over time, the minimum rate may decline to an even lower level. The premium base will be all of the bank's guaranteed liabilities. For example, a bank with $5 billion of assets and $4.5 billion of liabilities protected by cross-guarantees will pay an annual cross-guarantee premium of $900,000 ($4,500,000,000 x .0002). This contrasts with $5.25 million in BIF premiums that the bank will pay in 1991, assuming it has $3.5 billion of deposits and a BIF premium rate of 15 basis points ($3,500,000,000 x .0015).

The circumstances under which the premium formula can be adjusted during the contract term

The structure and business of a guaranteed bank could change sufficiently during a three-year contract period to warrant changes in the contract's pricing formula. A procedure for making these changes will have to be incorporated into the contract so that the entire contract will not have to be renegotiated every time some element of the guaranteed bank's business changes. This procedure is a potentially contentious aspect of the cross-guarantee concept and one in which binding arbitration might have to be used to resolve differences between the guarantors and the guaranteed bank about these changes.

The formula for calculating the monitoring fee paid to the guarantors' syndicate agent

The monitoring fee will cover the syndicate agent's operating expenses. The base for calculating the monitoring fee probably will be the total assets of the bank or holding company covered by the cross-guarantee contract. The syndicate agent's work in monitoring the financial condition of a guaranteed organization will not be specifically affected by the scope of the liabilities guaranteed since monitoring work will focus largely on the bank's assets. Thus, a guaranteed bank or holding company will be able to extend its cross-guarantee contract to cover its nondeposit liabilities for only the cost of the loss premium charged for those liabilities because such an extension will require very little additional monitoring work.

Negative covenants

Negative covenants are contractual restrictions or prohibitions. They also state what can occur if the offending condition is not eliminated. In effect, negative covenants are the functional equivalent of government regulations. These covenants are found in almost all loan agreements and bond indentures. A violation of a negative covenant or of any covenant in a contract is called an "event of default."

Certain events of default will allow guarantors to take over the guaranteed bank. These events of default undoubtedly will be structured to permit guarantors to take over a bank before it actually becomes insolvent.

One likely event of default will be a risk-sensitive premium that exceeds a certain level. In effect, a premium that exceeds a certain level will be tantamount to the failure of that bank. The author's research indicates that a risk-sensitive premium rate in excess of 70 or 80 basis points should be an event of default. A premium rate this high will effectively wipe out the bank's operating earnings available to stockholders, thereby making their stock worthless. Any attempt by a failing bank to achieve earnings above this level will quite likely entail a "go-for-broke" strategy that eventually will cost its guarantors even greater sums.

Another negative covenant might be a premium rate that rose more than a specified number of basis points during a specified time period. For example, a premium rate that rose more than 10 basis points during a three-month period or more than 15 basis points during a six-month period might constitute an event of default. Yet another event of default might occur if the market value of the guaranteed bank's assets dropped its equity capital below a certain percentage.

The terms and conditions of negative covenants in cross-guarantee contracts will be freely negotiated between the guarantors and the guaranteed bank just as will the other terms and conditions of the cross-guarantee contract. This freedom to negotiate will prevent the covenants from being too one-sided.

Cancelation terms

Guarantors will be able to cancel a cross-guarantee contract on a three- to six-months notice. However, cancellation will not take place on a whim, because guaranteed banks probably will insist, before signing a cross-guarantee contract, that a substantial number of the guarantors, perhaps those holding at least 75% or 80% of the dollar exposure of the guarantors, will have to vote to cancel the contract.

The FDIC should be notified of the cancellation, but it would not have to act at that time. Notification will simply permit the FDIC to closely monitor the guaranteed bank to make certain that it either obtains an acceptable replacement guarantee or is taken over by its existing guarantors.

If the guaranteed bank is in reasonably good financial condition at the time of cancellation, it should have little difficulty in obtaining new cross-guarantee coverage. Obtaining new cross-guarantee coverage from another syndicate of guarantors will be comparable to a nonfinancial corporation obtaining a line of credit at a new bank after its former bank cancels a line of credit or calls a loan.

If the guaranteed bank cannot obtain a replacement cross-guarantee from another syndicate of guarantors within the cancellation notice period, then the bank effectively will have failed. The bank may not be insolvent, but it will have failed in the marketplace in that no set of guarantors will want to guarantee it. In this circumstance, the bank's current guarantors will have to take it over and bear any and all losses incurred to fully protect the bank's depositors and other creditors while disposing of it. This takeover will not require any action or approval by the FDIC, because the takeover will occur under the terms and conditions of the cross-guarantee contract. Most likely, the syndicate agent will act on behalf of the guarantor banks in these relatively rare situations of failed banks.

There will be no basis for elected politicians to get involved in this takeover process, because the takeover will not differ substantively from a situation in which a debtor has run afoul of a negative covenant in a loan agreement or bond indenture. It is absolutely essential to the cross-guarantee process that no legislative or regulatory action can block the takeover of a bank by its guarantors. Only a court of law should have that power. Shifting the takeover or closure decision of a failed bank to the commercial marketplace from the political process represents a key advantage of the cross-guarantee concept over traditional regulatory methods for minimizing bank insolvency losses.

A guaranteed bank will be permitted to cancel its cross-guarantee contract at any time. However, the canceled contract will remain in effect until the moment that the guaranteed bank's new contract with another syndicate of guarantors has become effective. Cross-guarantee contracts most likely will provide that the guarantors can charge a cancellation fee to cover their unamortized cost of organizing the syndicate and negotiating the contract.

Nonrenewal

Nonrenewal procedures will essentially parallel cancellation procedures. Guarantors will have to give written notice to the guaranteed bank at least three months before the end of the existing cross-guarantee contract. The notice must state that they do not want to renew the contract. If the guaranteed bank cannot obtain a new cross-guarantee contract, its present guarantors will take the bank over and dispose of it. As in a cancellation situation, if the guaranteed bank cannot obtain a new cross-guarantee contract, it effectively will have failed. In either case (cancelation or nonrenewal), depositors and other guaranteed creditors of the bank will continue to be fully protected by the bank's guarantors until either a replacement set of guarantors is in place or the current guarantors take over the bank and dispose of it.

Box 12

The "stop-loss" provision: An essential safeguard for 100% cross-guarantees

The mandatory "stop-loss" provision in all cross-guarantee contracts is an absolutely key feature of the 100% cross-guarantee concept. The stop-loss feature will permit a first-tier guarantor to pass on its extraordinary guarantor losses to its own guarantors, referred to as second-tier guarantors. This stop-loss protection should kick in when a guarantor bank's total guarantor losses exceed five times the limit on the "projected annual premium" (PAP) that the bank can be committed to receive at any time. Thus, the stop-loss provision will prevent guarantor losses from wiping out all of a guarantor bank's excess equity capital (see Box 13). In reality, though, guarantor losses will first reduce the bank's current earnings before cutting into its equity capital.

Stop-loss protection, also known as "stop loss reinsurance," is widely used at Lloyd's of London (see Box 8) and elsewhere in the insurance world to prevent a domino effect (i.e., situations where one large insurance loss or a concentration of smaller losses triggers a number of insurance company insolvencies). Exhibit 2, (following page 8) illustrates the multiple tiers of guarantors through which extraordinary losses will flow.

If large guarantor losses flow to a second-tier guarantor from one or more first-tier guarantors of a failed bank, losses in excess of the second-tier guarantor's own stop-loss limit will then flow through to that guarantor's own guarantors. These guarantors will become the third-tier guarantors of the failed bank (i.e., guarantors two steps removed from the first-tier guarantors who directly absorb the insolvency losses spilling out of the guaranteed bank). In extremely severe situations, losses could even flow to guarantors beyond the third tier.

The mandatory use of a stop-loss provision in cross-guarantee contracts effectively will spread a very large bank insolvency loss or a cluster of losses across the entire banking system. It is this stop-loss provision that will place the earning power and the equity capital of the entire banking system -- the solvency safety net -- behind every guaranteed bank. However, it will be a rare event for failed bank losses to flow even to a second-tier guarantor, much less to third-tier guarantors and beyond.

As important, the stop-loss provision will insure that no bank will ever fail because of the losses it suffers as a guarantor. A bank might fail because of its own mismanagement, but not because of its guarantor activities.

If a bank did assume too many guarantees, and thus exposed itself to too many losses as a guarantor, then there will be an increased likelihood that some portion of these losses will be passed on to the bank's guarantors. This aspect of the stop-loss provision will give guarantors an important incentive to make sure that a bank they guarantee does not overcommit itself as a guarantor. A guaranteed bank's cross-guarantee premium rate will reflect, in part, the amount and riskiness of the cross-guarantee risks that the bank has assumed.

Box 13

The base equity capital concept: Establishing limits on 100% cross-guarantee risks assumed within the banking system

The base equity concept divides the capital of the banking system into two components: base equity capital and excess equity capital. Excess equity capital will be the only capital a bank can use for assuming cross-guarantee risks. All of the bank's equity capital, however, will be available to absorb losses growing out the bank's other activities. By focusing on the amount of excess equity capital in the entire banking system, the regulatory process can safely ignore the capital level in individual banks. That capital level will be the province of guarantor banks and of the risk-sensitive pricing formula.

Base and excess equity capital will be computed in accordance with the enabling legislation for 100% cross-guarantees. For example, the total amount of base equity capital held by all guaranteed banks at the start of any calendar year might have to be the greater of 2 percent of the market value of the total assets of the banking system or 100 times the average bank insolvency losses that guarantors collectively experienced over the previous five years.[44]

An example will illustrate the calculation of the base equity capital requirement for the banking system: If guaranteed banks collectively have $4.5 trillion in assets (at market value) and if the base equity capital requirement is 2%, then the base equity capital requirement for the banking system will be $90 billion ($4.5 trillion x .02).

Banks with very safe asset portfolios and little interest rate risk may be able to operate safely under their 100% cross-guarantee contracts with equity capital of less than 2%. Accordingly, the $90 billion base equity capital requirement will have to be redistributed across those banks with more than 2% capital. This redistribution process, which is illustrated in Exhibit 11 (see following page), will have the effect of raising the base equity capital requirement to an adjusted level of 2.1% or 2.2%. Only those banks with equity capital above this adjusted level will be able to enter new 100% cross-guarantee contracts and only to the extent to which their excess equity capital will permit these banks to assume new cross-guarantee risks. Banks that fall below the adjusted base equity capital level will not be permitted to enter new cross-guarantee commitments; however, their existing commitments will remain in place.

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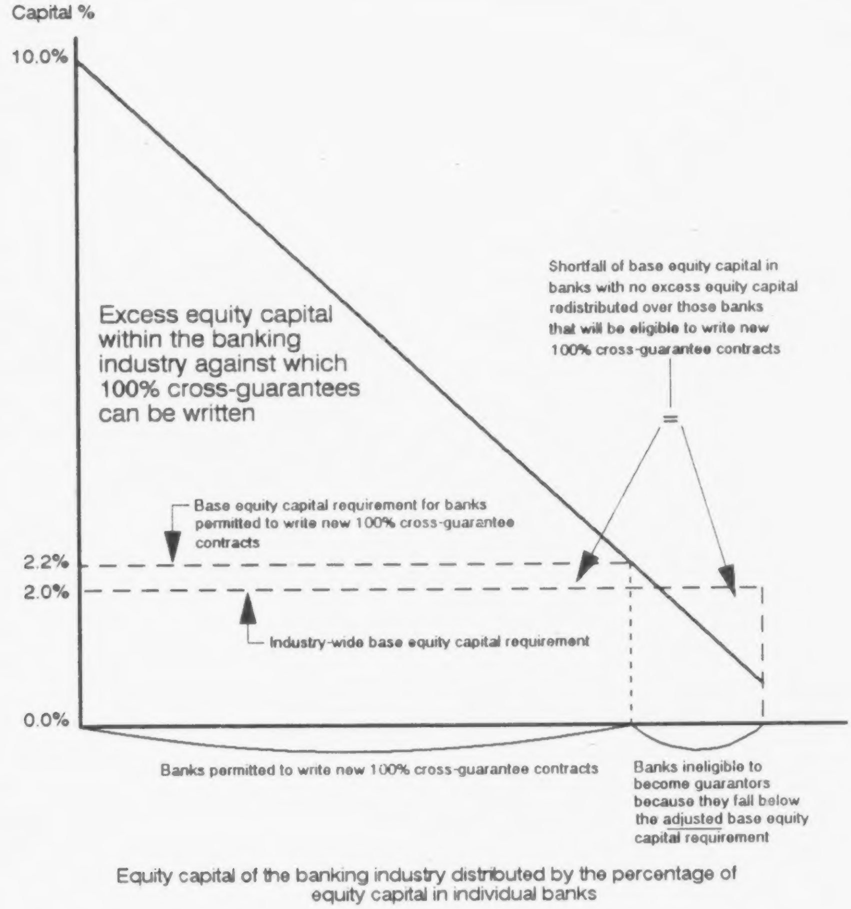
[44] A five-year period would permit the averaging of one or two high-loss years over other years in which losses were lower.

Exhibit 11

Determination of Adjusted Base Equity Capital Requirement for Banks with Excess Equity Capital



Note: Distribution of equity capital within the banking industry is assumed for illustrative purposes only.

For the sake of simplicity, the examples in this paper assume that the adjusted base equity capital requirement equals the base equity capital requirement.

Box 14

Two risk-diversification requirements imposed on guarantor banks

Risk diversification is an essential element of the cross-guarantee concept. To diversify their risk as guarantors, even large banks should assume just a small portion of many cross-guarantee risks. One-hundred-dollar units of "projected annual premium" (PAP units) offer an efficient way in which cross-guarantee risks can be readily diversified. PAP includes only the premium actually paid to guarantor banks; it excludes the monitoring fee that the guaranteed bank will pay directly to the syndicate agent.

Under the PAP concept, the smallest portion of risk assumed by guarantors will equal $100 of PAP to be paid by a guaranteed bank or pool of guaranteed banks. The total PAP for a guaranteed bank will equal the current amount of its protected liabilities times the premium rate it most likely will pay at the onset of its cross-guarantee contract.

An example will illustrate how PAP units will be calculated: If the projected annual premium rate for a guaranteed bank with $2 billion of protected liabilities is 2.5 basis points, that bank will pay a projected annual premium of $500,000 ($2 billion x .00025). This annual premium will be equal to 5,000 PAP units of $100 each ($500,000/$100). Thus, a bank can assume as little as .02% (1/5,000) of the risk of this guaranteed bank by assuming the risk associated with one PAP unit. The amount of risk associated with each PAP unit for this bank will be a maximum loss exposure of $400,000 ($2 billion/5,000); however, the practical loss exposure will be much less because insolvency losses in failed banks can easily be held to a few percentage points of liabilities, at most.

The division of cross-guarantee risks into PAP units of $100 each will be beneficial for two reasons. First, even the very smallest bank will be able to diversify or spread its cross-guarantee risks across a variety of larger banks and pools of smaller banks. For example, a bank with $10 million of assets and equity capital of $600,000 will have excess capital of $400,000. (The excess equity capital concept is discussed in Box 13.) Under the PAP income limitation discussed below, this bank could, therefore, earn $20,000 of cross-guarantee premium income annually ($400,000 times 5%), or 200 PAP units of $100 each. Thus, even this tiny bank could participate in as many as 200 different risk syndicates. This example demonstrates how the PAP feature will add depth and breadth to the cross-guarantee marketplace by permitting even small banks to participate in numerous cross-guarantee situations.

Second, larger banks with a greater capital capacity to assume cross-guarantee risks also will use the small size of PAP units to precisely tailor the cross-guarantee risks they assume in individual banks or pools of banks, as well as to assume cross-guarantee risks in many, many banks.

There should be two risk-diversification requirements imposed on guarantor banks, as follows:

1. PAP income limited to 5% of excess equity capital

The aggregate amount of PAP for which a bank has contracted as a guarantor should not at any time exceed 5% of its equity capital in excess of its base equity capital. This limitation should be set by the enabling legislation or perhaps by regulation. In effect, a guarantor bank's excess equity capital should be at least 20 times its total PAP. For example, a $600 million asset bank has total equity capital of $30 million and a base equity capital of $12 million. Its excess equity capital is $18 million ($30 million - $12 million). Five percent of this excess equity capital is $900,000. Therefore, this bank could not commit to receive in a year more than $900,000 in PAP, or 9,000 PAP units of $100 each.

The aggregate PAP limitation means that the bank's excess equity capital will not be wiped out by its guarantor losses unless its actual guarantor losses exceed 20 times its PAP. By way of contrast, the average property and casualty insurance company's equity capital will be wiped out if its losses in any one year exceed its premium income that year by about 40%. Thus, this 5% limit provides guarantor banks with an enormous margin of safety for the cross-guarantee risks it assumes.

The 5% limit also allows ample room for actual premium income to exceed PAP. Actual income will exceed PAP for two reasons: The guaranteed bank was riskier than initially projected and thus paid a higher premium rate, or the guaranteed bank grew more rapidly than projected.

Substantial excess equity capital in banks today

As of September 30, 1989, there was, conservatively, $106 billion of excess equity capital in American-domiciled banks, or 4.4 times as much as will be needed to adequately capitalize 100% cross-guarantees for all banks. Thus, banks on average will have to use only 23% of their excess equity capital to meet the total capital requirements of the cross-guarantee concept if there are no nonbank guarantors. The following calculation illustrates this point.

If the total PAP for all guarantor banks was $1.2 billion (which equates to an average premium rate of 3 basis points on $4 trillion of protected liabilities in banks with total assets of $4.5 trillion), the 5% requirement will require guarantor banks to collectively have at least $24 billion of excess equity capital ($1.2 billion/.05).

On September 30, 1989, solvent banks had $261 billion of equity capital at book value. If we assume that the market value of this equity capital was 25% less, these banks had $196 billion of equity capital on that date. The base equity capital requirement for these banks on September 30, 1989, was $90 billion ($4.5 trillion of assets x .02). Subtracting $90 billion from $196 billion leaves $106 billion, or 4.4 times the collective excess equity capital requirement of $24 billion.

Shortages of excess equity capital

A shortage of excess equity capital could develop that could impair the ability of the cross-guarantee marketplace to supply all of the cross-guarantees that were demanded at a rate that will not force a dramatic shrinkage of bank assets. A shortage could develop for three reasons. High guarantor losses could push up the base equity capital requirement, total equity capital among the guaranteed banks could decline, and/or cross-guarantee premium rates could increase dramatically.

However, if the shortage arose, it would not occur suddenly unless accompanied by a major national disaster. Thus, a steady shrinkage of excess equity capital over time will lead to corrective steps in the cross-guarantee marketplace that will make a shortage a temporary phenomenon at worst. Permitting nonbank firms to act as guarantors will effectively eliminate any concerns about a shortage of equity capital with which to underpin 100% cross-guarantees since there is substantial equity capital elsewhere in the American economy to meet this need.

If America experienced a major disaster, such as a widespread East Coast earthquake that caused several hundred billion dollars of damage, that event would weaken the equity capital underpinning of all economic actors and not just the banks. Public policy would have to respond to such a crisis, perhaps by permitting greater leveraging of the remaining bank equity capital until the banking system, along with the rest of the economy, was able to significantly rebuild its equity capital.

2. Guarantor exposure to any one bank limited to 5% of its total PAP capacity

No more than 5% of a bank's total capital capacity as a guarantor could be represented by that bank's guarantor commitment to any one bank or pool of banks. Since PAP represents an assessment of a guaranteed bank's risk, this means that a guarantor bank could not bet more than 5% of its total risk capacity on any one guaranteed bank or pool of guaranteed banks.

Box 15

Two risk-diversification requirements for any one cross-guarantee contract

Two risk-diversification requirements should be imposed on all 100% cross-guarantee contracts.

1. Larger banks will be required to have a greater number of guarantors than smaller banks so as to more widely diversify the cross-guarantee risk of the larger banks

Spreading the risk of a large bank more widely can be accomplished by reducing the percentage of a guaranteed bank's risk that any one guarantor can hold as the guaranteed bank grows in size. This declining percentage will ensure that the cross-guarantee risk will be spread more widely over first-tier guarantors as a guaranteed bank gets progressively larger. These percentage limits are set out in the following table.

Bank size (total assets)	Maximum percentage for any first tier guarantor	Minimum number of guarantors
Less than $100 million	5.0	20
$100-$500 million	3.0	34
$500 million-$1 billion	2.0%	50
$1-$10 billion	1.0%	100
More than $10 billion	.5%	200

An example will illustrate the application of this percentage limit: A bank with $20 billion of assets and $18 billion of deposits and other liabilities protected by cross-guarantees will have to have at least 200 guarantor banks (100%/.5%), each of which could assume no more than .5% of the bank's guarantor risk. If this bank has a cross-guarantee premium rate of 2 basis points, it will pay an annual cross-guarantee premium of $3,600,000, which will equal 36,000 PAP units ($3,600,000/$100). Thus, no one guarantor bank could commit to receive more than 180 PAP units (36,000/200) from this bank.

2. Minimum excess capital requirements backing up cross-guarantee contracts will block "closed loop" situations

Guaranteed banks or a pool of guaranteed banks also will have to contract with sufficiently large guarantors so that the amount of excess equity capital in each of the first two tiers of the guaranteed bank's network of guarantors, when added to the guaranteed bank's total equity capital, will have to exceed the minimums, expressed as a percentage of total assets. (See table below.)

This safeguard will prevent "closed-loop" situations that will defeat the broad risk-diversification feature of the 100% cross-guarantee concept. Closed loops will exist where a group of small banks (as few as 20) isolate their combined risk of insolvency from the rest of the banking system. The failure of one bank in a closed loop of banks could quickly trigger a string of domino-like failures among the other banks in the loop. The safeguard against closed-loop situations will be especially effective in preventing regional economic problems from causing a string of bank failures.

The percentage requirements to prevent closed-loop situations are set out in the following table. The higher percentages for the smaller banks are set to prevent closed loop situations that can intentionally or inadvertently develop among smaller banks.

	Total equity capital of the guaranteed bank, plus the excess capital of the guaranteed bank's guarantors	
Asset size layer of the guaranteed bank	First tier	Second tier
First $100 million	100%	300%
Next $400 million	60%	150%
Next $500 million	40%	100%
Next $9 billion	30%	50%
Next $40 billion	20%	25%
More than $50 billion	15%	20%

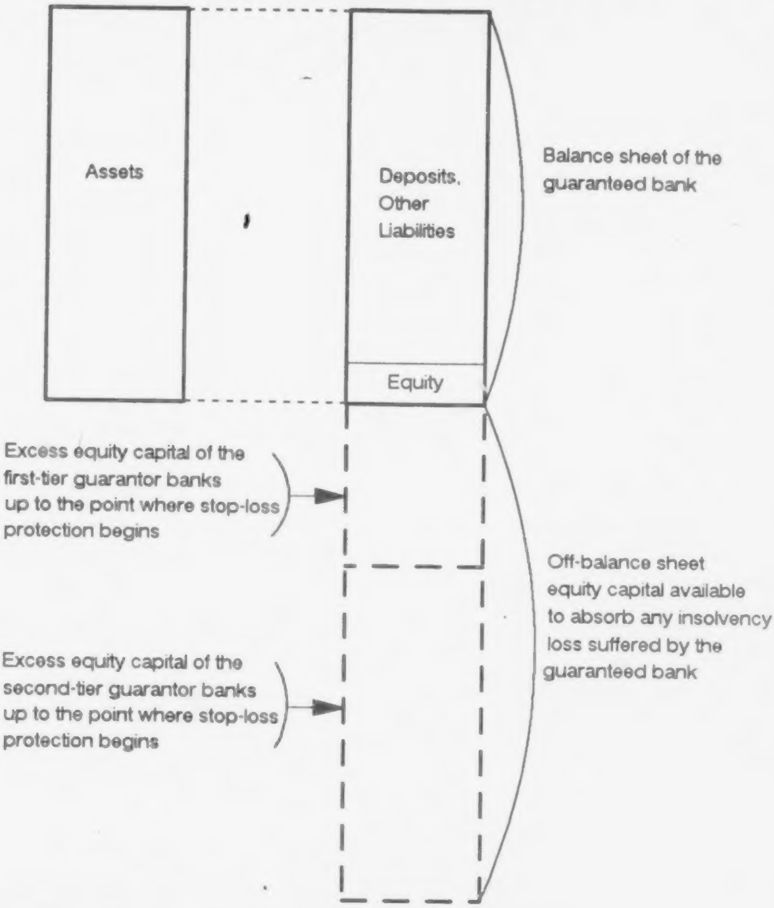
An example will illustrate the application of this requirement: A bank has $100 billion of assets and $4 billion of equity capital. Its first-tier guarantors collectively will have to have $14.74 billion of excess equity capital ($18.74 billion total requirement calculated from the table above less $4 billion of the bank's own equity capital). Its first- and second-tier guarantors collectively will have to have $21.9 billion of excess equity capital ($25.9 billion total requirement less $4 billion of the bank's own equity capital). Exhibit 12 (see next page) further illustrates the relationship of a guaranteed bank's balance sheet to the equity capital of its first- and second-tier guarantors.

The loss-absorbing capacity of the guarantor banks will be even greater than the percentages shown in the table above since the table does not count the loss-absorbing capacity of the guarantor banks' current earnings.

Small banks will have no difficulty meeting this percentage test because of the large amount of excess equity capital in the banking system relative to each small bank's cross-guarantee needs.

Exhibit 12

Illustration of the Off-Balance Sheet Equity Capital Strength That Would Be Available to Guaranteed Banks under Their 100% Cross-Guarantee Contracts


Assets
Deposits, Other Liabilities
Equity
Balance sheet of the guaranteed bank
Excess equity capital of the first-tier guarantor banks up to the point where stop-loss protection begins
Excess equity capital of the second-tier guarantor banks up to the point where stop-loss protection begins
Off-balance sheet equity capital available to absorb any insolvency loss suffered by the guaranteed bank

Note: An insolvency loss will develop when the total of the guaranteed bank's deposits and other liabilities exceeds the value of the bank's assets. The off-balance equity capital (i.e. the excess equity capital of the guarantor banks) will then be drawn upon to make up the amount by which the guaranteed bank's liabilities exceed the value of its assets. Losses, if any, exceeding the excess equity capital of the first two tiers of guarantor banks would flow through to the bank's third-tier guarantors.

The FDIC will have to be empowered to cancel any cross-guarantee agreement in which it detects a closed-loop condition.

Box 16

Stopping bank runs under the 100% cross-guarantee concept

Guarantors, with Federal Reserve backup, if necessary, will provide whatever liquidity is needed to stop runs on a bank they have guaranteed. Guarantors will not increase their risk exposure to the bank by advancing cash to it since they already are liable for any insolvency loss that the bank may suffer. In fact, guarantors will willingly advance funds to the troubled bank so that it does not have to sell any assets at "fire sale" prices to raise cash. Fire sales losses will add unnecessarily to the guarantors' cost of disposing of a failed bank. Guarantors will try to avoid this cost, if at all possible.

Under 100% cross-guarantees, the macroeconomic effects of bank runs will be momentary and of no material consequence, if guarantors provide sufficient cash to a bank that is experiencing heavy deposit outflows. Most of the money the guarantors deposit in a bank that is experiencing heavy deposit outflows will flow right back into the banking system as depositors in the troubled bank shift their deposit balances by check or wire transfer into other banks. Checks or wire transfers deposited into money market accounts or the like will, in turn, be redeposited in the banking system. The combined balance sheet of the banking system will not change to the extent that deposits are shifted about in this fashion. If necessary, the Fed, through its open-market operations, can quickly and easily sop up any money created to help a troubled bank so as to quickly nullify the inflationary potential of an expanded money supply.

Some depositors in a troubled bank might insist on withdrawing their deposits in currency. To the extent necessary, liquidity pumped into a bank experiencing a run will be used to buy currency from the Fed. However, the Fed can then pump the funds received for the currency back into the money supply by buying Treasury securities from the general public. This action also will hold constant the federal government's aggregate debt held by the public (currency plus interest-bearing bills, notes, and bonds), thus totally neutralizing any flight to currency.[45]

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[45] Stuffing currency into mattresses or similar hideaways is neutral for the economy, beneficial to the federal government, and detrimental only to the currency owner, provided the Federal Reserve issues sufficient additional currency to hold constant the amount of currency actually circulating in the economy. Because U.S. currency is nothing more than non-interest bearing debt of the federal government, each additional billion dollars stuffed into mattresses saves the federal government at least $80 million annually in interest outlays at current interest rates. This money is not lost for investment purposes; the government's borrowings of

Banks supplying emergency liquidity to a bank may momentarily violate existing requirements for maintaining cash reserves at the Federal Reserve. However, this violation is not a substantive economic problem, because reserves today exist largely to help reduce the federal government's interest-bearing debt. Banks failing to meet government-mandated reserve requirements while supplying emergency liquidity either could borrow temporarily at the Fed's discount window (until they otherwise restore their reserves to the mandated level) or could explicitly pay a "reserve tax," which would equal the interest rate on short-term Treasury debt times their reserves shortfall.

The combined liabilities of the guaranteed banks will decrease to the extent that depositors in troubled banks transfer their deposits by check or wire transfer to foreign banks. The depositors then present the check or wire transfer to a guaranteed bank for payment. The process of paying this check or wire transfer will have the effect of transferring cash out of the network of guaranteed banks.

The guaranteed banks might then suffer fire sale losses in selling assets (loans and investments) to raise the cash demanded by the foreign banks in such a situation. However, given the vast size of the American banking system, it is unlikely that massive dollar amounts will flow from a troubled guaranteed bank into the accounts of foreign banks. Thus, fire sale losses will be rare; any such loss will simply be an unavoidable expense that the guarantors of the troubled bank eventually will have to incur as part of the cost of meeting their commitment as guarantors. Borrowing at the Fed discount window would help guarantors to lessen the need for such quick asset sales.

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interest-bearing debt are simply reduced by an equivalent amount. The currency owner loses because the currency does not generate interest income. Thus, currency stuffed into mattresses has the same effect on the economy as U.S. currency circulating outside the United States or residing in foreign mattresses.

Box 17

Why banks and others will be willing to be guarantors

Banks and other parties will be willing to act as guarantors under the 100% cross-guarantee concept because the guarantor activity promises to be reasonably profitable for them. Viewed from another perspective, sound banks that assume guarantor risks will collect sufficient premium income to substantially offset their own 100% cross-guarantee premium expense.

The key element to profiting as a guarantor is that the design of the 100% cross-guarantee concept will force guarantors to assume small pieces of many cross-guarantee contracts rather than large slices of just a few contracts. Since few banks, if any, will fail in any one year under the 100% cross-guarantee concept, a guarantor will receive premium income from many banks (hundreds or perhaps a few thousand) while absorbing losses from just a few failures. Thus, most banks will earn a profit every year from the guarantor risks they assume.

A guarantor's losses in any one year should be low relative to the premium income it collects as a guarantor. It will be rare for a guarantor's losses to exceed 50% of its total guarantor income. It will be rarer yet for a guarantor's losses in a year to exceed its total guarantor income that year.

Guarantors in turn will earn good returns on the equity capital they allocate to their cross-guarantee activities. They should allocate equity capital on a one-to-one basis (i.e., the equity capital a bank commits to its guarantor activities should equal the guarantor premium income it collects annually). Expressing an equity capital commitment as a multiple of annual premium income reflects the accepted method for determining the capitalization of property and casualty (P&C) insurance companies.

For P&C insurers, risk exposure, as a practical matter, is measured in terms of the annual premium earned to insure a risk rather than in terms of the potential loss exposure, which in many cases is so astronomical as to be irrelevant. In reality, an insurer's total annual premium income is the appropriate measure of its total risk exposure since the premiums it collects should bear a reasonable relationship to the total insurance losses it pays out annually. In effect, losses paid represent an insurer's actual realized risk.

The one-to-one ratio of premium income to capital for guarantor activities compares very favorably with the capitalization of American P&C companies. For the 1980-88 period, American P&C companies experienced an earned-premium-to-policyholders surplus ratio that ranged from 1.70-to-1 to 1.98-to-1 and averaged 1.85-to-1.[46] In 1988, the most recent year for which data are available, P&C insurers earned $200 billion in premiums and the policyholders' surplus of these companies averaged $111.1 billion, giving the industry a relatively favorable premium-to-surplus ratio of 1.80-to-1.

Like any P&C insurer, a guarantor needs equity capital primarily to absorb insurance losses in excess of its premium income. A one-to-one premium-to-capital ratio for guarantor activities means that a guarantor's losses, net of income tax recoveries, will have to be twice the level of its premium income for one full year before the equity capital a bank allocated to its guarantor activities will be wiped out by these losses.[47]

This level of loss will be equivalent to a "combined ratio" in the P&C industry of 260%.[48] The combined ratio is the ratio of a P&C company's losses incurred to premium earned plus its ratio of commissions and expenses incurred to its premiums written. A 260% combined ratio lies far outside the history of the P&C industry. In the 1980-88 period, for example, the combined ratio of American P&C companies ranged from 103% to 118% and averaged 110%. A combined ratio as high as 130% usually signals that an insurer is sinking toward insolvency.

A one-to-one ratio of premium income to capital for allocating capital to guarantor activities also is very conservative in light of the very dynamic nature of cross-guarantee premium rates: They will be adjusted as frequently as weekly or biweekly to reflect changing levels of risk in a bank. By contrast, P&C companies and Lloyd's insurance syndicates (see Box 8) usually can risk-adjust their premium rates just once a year.

On the basis of the one-to-one ratio, if a bank earned $2 million annually in guarantor premium income, it should consider that it has effectively committed $2 million of its equity capital to absorb guarantor losses in excess of its premium income. However, it will not be necessary for the bank to actually set this capital aside in a special subsidiary or to deposit it in a special reserve fund.

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[46] Calculated by the author from data in annual editions of "Insurance Facts: Property/Casualty Fact Book," New York, Insurance Information Institute.

[47] If we assume that the amount of equity capital allocated to a bank's guarantor activities will equal the bank's annual guarantor premium income, losses as a guarantor (net of tax savings) would have to equal the bank's annual premium income plus an equal amount of capital, or twice the amount of capital allocated to the bank's guarantor activities.

[48] If we assume a combined federal/state tax rate of 38%, losses in excess of premium income will be deductible from the guarantor's other income. Losses that are beyond premium income and that are equal to 160% of premium income will generate tax savings equal to 60% of premium income (160% x 38%). This will give an after-tax loss equal to 100% of premium income.

Permitting equity capital to do double duty, as now occurs at Lloyd's, is an essential element to both the efficiency and the capital strength of the cross-guarantee concept. It is not necessary -- and, in fact, it is undesirable -- to physically segregate equity capital solely for the purpose of absorbing bank insolvency losses. Enough capital could not be set aside to cover catastrophic losses without seriously impairing the capital base available to the banking system between catastrophes.

Because a guarantor's losses usually will be low relative to its premium income, the guarantor should earn a very respectable after-tax return on the equity capital it commits to its guarantor activities. An example will illustrate this point. If a guarantor's losses equal 50% of its premium income and if the administrative cost it incurs in assuming and monitoring prospective guarantor risks equals another 20% of premium income, then the bank will earn a 30% pre-tax profit margin on its guarantor income.

Assuming a one-to-one premium-to-capital ratio, the 30% pre-tax profit margin will equate to an approximate 19% after-tax return, at current tax rates, on the equity capital the bank allocates to its guarantor activities. This return will be in addition to whatever return the bank earns on the investment of this capital in its own income-producing assets. This is precisely the way 28,500 individuals earn a profit from their membership at Lloyd's of London.

Box 18

Fundamental principles of the 100% cross-guarantee concept

1. Every dollar of deposit (principal plus accrued interest) in a guaranteed bank will be protected at all times against any type of loss; protection of other liabilities will be optional.

2. The original terms of withdrawal for all deposit contracts always will be honored without hesitation or restriction.

3. The equity capital of numerous guarantors -- the solvency safety net -- always will be standing by to absorb losses that exceed the equity capital of a guaranteed bank. If necessary, this solvency safety net will encompasses the earning power and equity capital of the entire network of guaranteed banks as well as nonbank guarantors.

4. The premium rate structure for cross-guarantees will be negotiated between a bank and its guarantors. It cannot be overridden by Congress or regulators.

5. The decision of guarantors to close a failing bank cannot be overridden by the political process. However, the FDIC could force guarantors to close a failing bank if the guarantors for some reason did not close that bank under the terms of the cross-guarantee contract.

6. No guarantor can ever fail by virtue of being a guarantor. The stop-loss provision that will be incorporated in every cross-guarantee contract will cause a guarantor's losses, which might otherwise cause it to fail, to flow through to its own guarantors.

7. Every guarantor also will be guaranteed as to its cross-guarantee commitments.

8. The cross-guarantee marketplace will be structured so that guarantors will have the widest possible range of risks to accept or decline. Likewise, guaranteed banks will have the largest possible range of guarantors with whom to secure their 100% cross-guarantee.

Box 19

Two historical precedents for the 100% cross-guarantee concept

Two close parallels demonstrate the unequaled capital strength of the essentially unlimited liability feature of cross-guarantees. First, three state-chartered deposit insurance systems that operated before the Civil War without any losses to depositors or holders of transferable notes (currency) represent the closest historical parallel to cross-guarantees. All three systems had one feature in common, a "mutual guarantee without limit." The states in which these systems operated were Indiana (1834-65), Ohio (1845-66), and Iowa (1858-66). All three of these state systems were effectively driven out of business by national banking legislation that levied a punitive tax on the transferable notes that state-chartered banks issued before the Civil War.

The "mutual-guarantee-without-limit" feature of these three plans represents a significant element of the 100% cross-guarantee concept. However, the 100% cross-guarantee concept will improve on the Indiana, Ohio, and Iowa plans in one important way: 100% cross-guarantees will be accompanied by risk-sensitive premiums. The administrators of the three mutual guarantee plans relied instead on traditional bank examination and supervision to contain bank insolvency losses.

The Indiana plan also is notable in this regard: It operated very successfully for 31 years (1834-65) without any central reserve fund. Actual losses that were incurred when a bank failed were levied on the other Indiana banks as insolvency losses were paid.

The other 11 state deposit insurance schemes for commercial banks that operated before the Depression, as well as the various state-sanctioned S&L deposit insurance schemes that have operated in this country since World War II, have all failed. None of these systems had the mutual-limit-without-guarantee feature of the Indiana, Ohio, and Iowa plans.[49] All of the state plans, except Indiana, Ohio, and Iowa, suffered the same flaw found in federal deposit insurance: a finite and rather limited amount of reserves with which to absorb losses. When these reserves are exhausted by bank insolvency losses, one of two things occurs: Depositors suffer losses, or taxpayers bail out the plan.

Second, the Scottish banking system before 1845 also demonstrated the virtues of unlimited liability in protecting depositors and noteholders from bank insolvency losses.[50] These Scottish banks effectively were partnerships in which the partners had unlimited liability. Over the 130 year period from 1716 to 1845, depositors and noteholders in these banks suffered a minuscule loss of principal (32,000 pounds).[51] In contrast to the English banks of the day, the Scottish banks "... stood ready to lend one another liquid funds in the event of a short-term disturbance."[52] This form of banking declined in Scotland as a result of the growing dominance of the Bank of England.

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[49] An excellent summary of the features of the 14 state deposit insurance plans that operated before the Depression will be found in Charles W. Calomiris, "Deposit Insurance: Lessons from the Record," Economic Perspectives, Federal Reserve Bank of Chicago, May/June 1989, pages 10-30.

Both the three state plans and the Scottish banking system featured unlimited liability for, respectively, their member banks and their partners. However, the stop-loss feature of the 100% cross-guarantee system described in Box 12 effectively caps any one guarantor's losses by spreading potentially bankrupting losses over many other guarantors.

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[50] The definitive work on the Scottish banking system is Lawrence H. White, "Free Banking in Britain: Theory, Experience, and Debate, 1800-1845," Cambridge University Press, 1984.

[51] Ibid., page 41.

[52] Ibid., page 45.

Box 20

The 100% cross-guarantees will be very beneficial for community banks

While banks of all sizes will prosper once they opt for 100% cross-guarantees, cross-guarantees will be especially beneficial to community banks. Thus, one of the most attractive features of 100% cross-guarantees for the American banking system is that this concept will enhance the opportunity for small community banks to prosper alongside much larger American banks that are becoming increasingly capable of internally obtaining geographical risk dispersion through state-wide and interstate branching.

100% cross-guarantees will allow community banks to attract deposit balances of more than $100,000. Depositors in small banks are more concerned about FDIC enforcement of the $100,000 federal deposit insurance limit than are depositors in large banks because smaller failed banks are much more likely than larger failed banks to be dealt with through a liquidation or deposit transfer that could impose losses on deposit balances of more than $100,000.

The 100% cross-guarantee concept will fully protect depositors in community banks even though guarantors will be more likely to liquidate a smaller failed bank than a larger one. With 100% cross-guarantees, the manner in which a failed bank is disposed of will not discriminate against the deposit-raising ability of community banks. Protecting all deposit balances is why the 100% cross-guarantee concept effectively will end the FDIC's too-big-to-fail policy that small banks believe puts them at a competitive disadvantage with large banks.

The 100% cross-guarantees will lower funding costs more for community banks than for larger banks. The 100% cross-guarantee concept will lower funding costs for all banks. However, the AAA rating that will be bestowed upon all banks protected by cross-guarantees will reduce the cost of funds for small banks more than it will for large banks.

The 100% cross-guarantees will save community banks substantial sums in auditing and other administrative expenses. It is unlikely that guarantors will require that smaller banks obtain annual certified audits, because syndicate agents will monitor these banks continuously. Also, the monitoring process should lower the cost of both banker's blanket bond and officers' and directors' liability insurance for community banks. Risk-sensitive premium rates also will provide the managers of a community bank with an important and timely indicator of the overall condition of their bank. These banks usually lack the sophisticated financial management systems that routinely provide the management of larger banks with this type of information. Together, these savings and intangible benefits will far offset the somewhat higher costs that syndicate agents will incur in underwriting and monitoring 100% cross-guarantee risks in community banks.

Box 21

The 100% cross-guarantees will completely eliminate the daylight overdraft risk

The daylight overdraft risk in the payments system, an increasing concern to the Federal Reserve System in recent years, will disappear completely with 100% cross-guarantees.

The daylight overdraft risk essentially is the risk that a bank will suddenly become insolvent. Concern about the daylight overdraft risk reflects the unfounded fear that a bank might not be able to cover an overdraft at the end of the day. A daylight overdraft, which becomes evident at the end of the banking day, occurs whenever more money is transferred out of a bank during the day than is transferred into the bank. This overdraft will be owed to the Fed (and indirectly to the taxpayer) for transfers made over the Fed wire. The overdraft will be owed to counter parties for transfers made through CHIPS (Clearing House Interbank Payments System); however, CHIPS recently began to require that banks participating in CHIPS fully collateralize the daily overdraft limits they have established with CHIPS.

An uncovered daylight overdraft can occur only when a bank is unable to borrow the funds needed to cover the overdraft because the bank is suddenly discovered to be insolvent or nearly so. However, banks, especially larger ones, do not become insolvent overnight; they take years to sink to that condition. Thus, a sudden bank insolvency can occur today only because of massive regulatory incompetence (i.e., allowing a bank to become insolvent while ignoring numerous marketplace signals that the bank was failing). The near impossibility of a bank insolvency suddenly occurring is reflected in the fact that the Fed has experienced difficulty in pricing the daylight overdraft risk.

The solvency safety net formed by 100% cross-guarantees will fully protect the Fed and CHIPS against the failure of a bank to completely eliminate, at the end of every business day, any net overdraft in its Federal Reserve and CHIPS accounts that arose that day as a result of its wire transfer activities. Using cross-guarantees to completely eliminate the daylight overdraft risk will spare banks of Fed-fed hysteria that is forcing banks to needlessly invest millions in order to minimize the buildup of overdrafts during the business day. CHIPS would be able to abandon its recently implemented collateralization requirements for daylight overdrafts. Cross-guarantees also would enable competing systems for funds transfer to emerge. This in turn will permit the Fed to withdraw from this activity, as it has indicated it would like to do.[53]

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[53] Jeanne Iida, "Fed Planning to Privatize Funds-Transfer Operations," American Banker (May 3, 1990): 1.

Box 22

The 100% cross-guarantees will correct the fatal flaw of the pre-Federal Reserve clearinghouses

Before 1914, an association of banks in a city or town, called a clearinghouse, frequently was able to supply emergency liquidity, in the form of currency and gold, to solvent member banks. However, this assistance generally was not provided to insolvent members; further, many banks, particularly in rural areas, did not belong to any clearinghouse.

Clearinghouses became very adept at distinguishing between their solvent and insolvent members[54] and in helping to maintain the liquidity of deposits in solvent banks. When currency and gold ran short within the banking system during a banking crisis, the clearinghouses would issue "clearinghouse loan certificates" (in effect, private currency) to their solvent members to pay out to depositors. In more extreme circumstances, the clearinghouse members agreed to a "partial suspension" of banking activities (i.e., the banks would agree to remain open for all banking transactions except paying out currency to depositors). Despite these actions, it was unrequited runs on insolvent clearinghouse members and banks that were not members of a clearinghouse that caused the banking panics that periodically struck the American economy between the Civil War and World War II.[55]

The inability of clearinghouses to maintain liquidity for all banks at all times was the fatal flaw of the clearinghouse system. Because of this flaw, the emergency lending or lender-of-last-resort function of the clearinghouses was effectively nationalized when the Federal Reserve System was created in December 1913.

The cross-guarantee concept corrects the fatal flaw of the clearinghouses. Guarantor banks, with Fed backup, if necessary, will provide whatever emergency liquidity is needed by guaranteed banks regardless of their financial condition. By providing liquidity to all, the cross-guarantee concept will effectively return the lender-of-last-resort function to the banking system itself. The Federal Reserve System could then limit its emergency lending to just a back-up role and thus focus on its monetary management activities.

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[54] Gary Gorton, "Private Clearinghouses and the Origins of Central Banking," Business Review of the Federal Reserve Bank of Philadelphia, January/February 1984, p. 10.

[55] Gerald P. Dwyer, Jr., and R. Alton Gilbert, "Bank Runs and Private Remedies," Bulletin of the Federal Reserve Bank of St. Louis, May/June 1989, pages 43-61.

Box 23

The 100% cross-guarantees will enhance the domestic and international competitiveness of American-domiciled banks

The international competitiveness of American-domiciled banks will be greatly enhanced because of the lower operating costs and operational efficiencies that cross-guarantees will permit. Other nations will be forced to respond to the competitive advantages that American-domiciled banks will enjoy with cross-guarantees. However, American banks will enjoy this distinct competitive advantage while other nations are implementing their versions of cross-guarantees _if_ the United States becomes the first country to authorize cross-guarantees.

Banks domiciled in other countries that continue operating under the Basle risk-based capital standards will be at a particular disadvantage (see Box 3). Cross-guarantees, however, will largely supplant the Basle capital standards. Even after cross-guarantees are implemented by other countries, American-domiciled banks will still have an improved competitive advantage, compared to their situation today, because they no longer will be uniquely burdened by the high costs of bank insolvencies and obsolete regulations that foreign-domiciled banks do not bear today.

Box 24

Why Congress should authorize 100% cross-guarantees

Cross-guarantees will --

1. Eliminate taxpayer risk in protecting the principal, interest, and liquidity of bank deposits.

2. Broaden depositor protection and thereby increase systemic stability by explicitly protecting every dollar of bank deposits.

3. Bring about prompt closure of failing banks.

4. Reduce the economic losses and distortions caused by imprudent lending in badly managed banks.

5. Promote greater operational efficiency in the banking system while melting away excess banking capacity.

Appendix

Risk-sensitive price for 100% cross-guarantees: How it will work

The marketplace for cross-guarantees will determine how risk-sensitive premium rates for cross-guarantees will be calculated. That is, the bank to be guaranteed and an ad hoc syndicate of guarantors, working through a syndicate agent, will negotiate the formula under which the risk-sensitive premium rate will be determined over the life of the cross-guarantee contract between the syndicate and the guaranteed bank. There will be no need for any federal or state regulation of this pricing process. Thus, this discussion is merely a speculation as to how risk-sensitive pricing will evolve in the cross-guarantee marketplace.

Calculating the loss premium

Risk-sensitive premiums will serve three purposes: (1) to compensate guarantors for the risks they assume as syndicate members (2) to discourage guaranteed banks from taking undercompensated risks, and (3) to signal to a guaranteed bank's cross-guarantee syndicate when the syndicate should take over that bank because it is failing (i.e., on the verge of becoming insolvent).

The first purpose, compensating guarantors, will provide the basis for determining the risk-sensitive premium rate. The premium received by a guarantor must cover two types of expenses it will incur by virtue of being a guarantor: (1) the insolvency losses the guarantor can expect to pay out over time, which are referred to as the expected rate of loss, and (2) the administrative expenses a guarantor will incur in managing its guarantor risks. The remainder of the premium that the guarantor receives will be the profit it must earn over time in order to be enticed to serve as a guarantor.

Thus, the premium rate for cross-guarantees will be calculated as follows:

[the probability (**P**) the bank will fail
within a given time frame]
times
[the expected insolvency loss (**L**) in that bank
that its guarantors will pay if failure occurs]
times
[the administrative expense and profit multiplier(**M**)]
equals
the expected rate (**R**) of loss;

Or: **P** x **L** x **M** = **R**.

Bank failure, or guarantor takeover, under the cross-guarantee concept will occur when the current value of a bank's assets declines to the point where it slightly exceeds the current value of the bank's liabilities. An actual insolvency loss in a failed bank will arise, however, only when the current value of the bank's liabilities exceeds the current value of its assets.

Essentially, the premium rate charged by the syndicate will vary directly with the probability of the bank's failure. Exhibit 13 (see following page) illustrates the relationship between the probability of bank failure during the next year and the loss associated with a failure. This relationship in the graph shows two different loss rates: 1 basis point and 4 basis points. The lower line in Exhibit 13 illustrates the range of combinations of probability of loss and percentage of loss, if failure occurs, that will generate an expected rate of loss of 1 basis point. For example, if two banks per 1,000 fail each year at an average insolvency loss of 5 percent per dollar of guaranteed liabilities, the loss rate will be 1 basis point ((2/1,000) x .05). The same loss rate will occur if 10 banks per 1,000 fail each year at an average insolvency loss of 1 percent ((10/1,000) x .01).

Because guarantors will close failing banks much more quickly than any government deposit insurer ever will, the loss percentage to use in selecting the failure rate on which to predicate a premium rate will be much lower than the FDIC's experience over the last decade. For the 1981-88 period, the FDIC's reported losses, as a percentage of deposits, averaged 14.9% and ranged from 9.9% in 1984 to 28.1% in 1983.[56]

The expected loss rate of 1 basis point is the likely rate to be factored into the risk-sensitive pricing for the vast majority of banks that have a very low probability of failing within the next year. In effect, it is extremely unlikely that one bank among every 100 (10 failures per 1,000 banks) paying the likely minimum cross-guarantee premium rate of 2 basis points would fail every 12 months, much less have a loss associated with that failure. This point clearly evidences the conservatism inherent in even the low premium rates that Exhibit 13 suggests are possible for sound banks.

The upper line in Exhibit 13 illustrates the combinations of failure rates and loss experiences that will generate a loss rate of 4 basis points. This is the loss rate that might be anticipated for moderately risky banks. Even with moderately risky banks, a reasonably diligent syndicate agent is unlikely to let one such bank per hundred fail annually with an insolvency loss equal to 4 percent of the guaranteed liabilities of the failed bank. It simply is not

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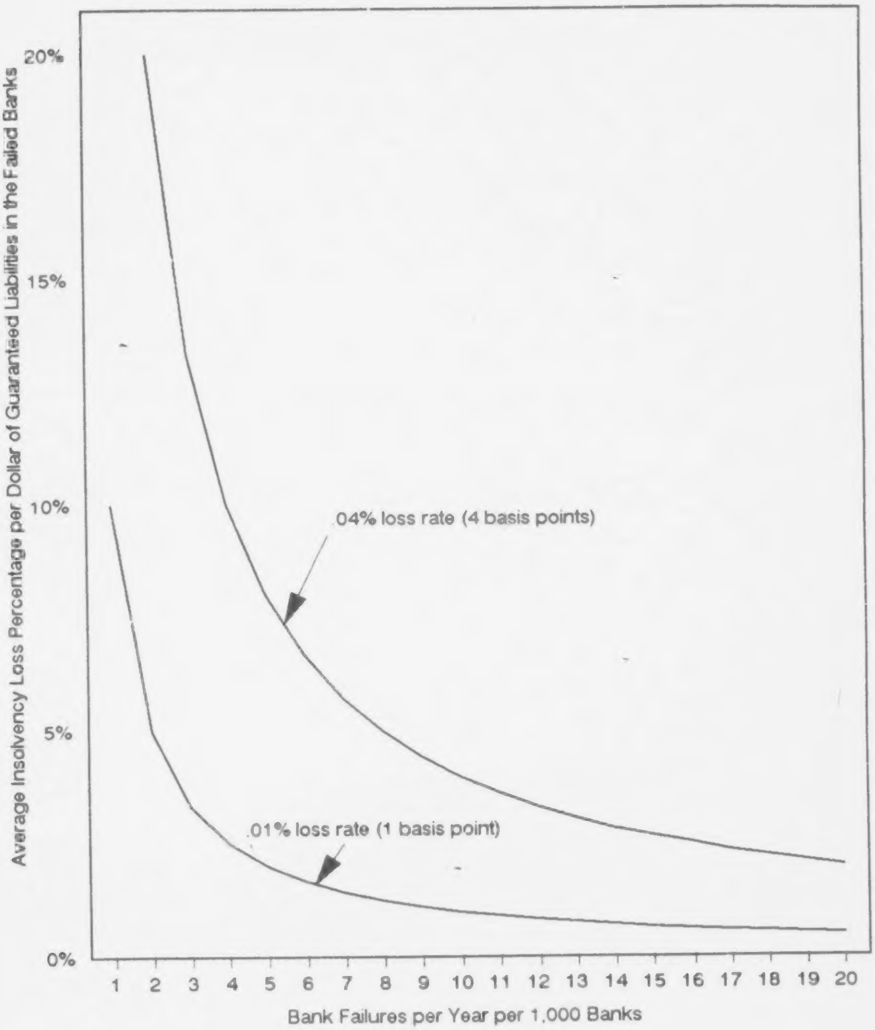
[56] Calculated from data in Tables 122, 123, and 125 of the 1988 FDIC report, Table 123 of the 1987 and 1986 FDIC annual reports, and the Continental Illinois quarterly report to stockholders for June 30, 1984.

Exhibit 13

Combination of Probability of Failure and Insolvency Loss Percentage to Give Constant Expected Rates of Loss of .01% and .04%



that difficult to monitor risky banks and then to take them over as they approach insolvency.

Perhaps the most important point that Exhibit 13 demonstrates is the importance of taking over a failing bank before it becomes insolvent. Timely takeovers with very little loss associated with each failed bank can accommodate a very high failure rate at very low cost to guarantor banks. This is why shifting the takeover decision on failing banks to guarantor banks is perhaps the most valuable feature of the 100% cross-guarantee concept.

Administrative expenses and profit

The expected rate of loss most likely will be doubled to arrive at the premium rate paid to guarantor banks. Thus, an expected rate of loss equal to 1 basis point (.01%) will become a 2 basis-point premium rate. An expected loss rate of 4 basis points (.04%) will become an 8 basis-point premium rate. Doubling the expected loss rate means that over time guarantor banks will expect their actual cross-guarantee losses to not exceed 50% of the premium income they collect. This figure contrasts favorably with the property and casualty (P&C) insurance industry in which losses on average consume 80% of premium income.

Administrative expenses incurred by a bank or other firm by virtue of being a guarantor should not exceed more than 20% of its premium income. These expenses, which will cover the time and expense that bank personnel devote to reviewing prospective cross-guarantee risks and in monitoring the guarantor's existing risks, will be distinct from the monitoring expenses incurred by the syndicate agent. This 20% estimate, which is lower than the operating expense percentage of property and casualty insurance companies, is based on the author's assessment of the time that employees of a hypothetical guarantor will devote to managing the guarantor's cross-guarantee risks.

The remainder of the premium income, at least 30%, will represent the profit a guarantor bank will earn on the equity capital it attributes to its guarantor activities. This percentage will translate into a 19% after-tax return on equity capital, assuming the bank allocates to its guarantor activity equity capital equal to its annual premium income. This potential rate of return highlights a key reason why banks will be willing to be guarantors: to earn a profit. The potential profitability of being a guarantor bank is explored in more detail in Box 17.

Assessing the probability and cost of failure

A reasonable speculation can be offered on how risk-sensitive premiums will be set because elements of this type of pricing are widely used elsewhere in the financial markets, specifically in portfolio management, option pricing, and asset securitization.

Option pricing is a particularly appropriate parallel for risk-sensitive pricing because the cross-guarantee contract, like any other type of insurance contract, is nothing more than an option on the insurer's equity capital. The nature of this option is discussed in Box 7. Thus, the risk-sensitive cross-guarantee premium is the option price that the guarantor bank pays so that equity capital can be drawn, if necessary, from guarantor banks to protect the depositors and other creditors of the guaranteed bank from any loss if losses in the guaranteed bank exhaust its equity capital.

One study by two Federal Reserve economists clearly demonstrates that using just a few pieces of financial data can reasonably assess the probability of failure for FDIC-insured banks.[57] The probability of failure calculated in this study was based on six lagging measures of banking risk derived from quarterly bank call reports. On the basis of this study, banks would have paid premium rates that ranged from just 2.4 to 100 basis points even though the authors assumed the same magnitude of loss for all failed banks. Factoring in the likely magnitude of loss would have allowed for even more sharply differentiated premium rates.

Two sets of factors will most likely be used in a statistical formula to determine the probability that a bank will fail. These factors are the bank's financial risk and its procedural or operations risk. Financial risks include mismatched interest rate exposures, credit risks, foreign exchange risks, and cross-border currency exposures. Procedural or operations risk arises when established procedures are not followed in conducting specific banking activities, such as granting loans, entering foreign exchange contracts, processing transactions, etc. Each risk component will be discussed in turn.

Financial risk

Assessing financial risk is based on the following premise. Bank creditors, including guarantors, can be protected from bank insolvency losses in one of three ways: internal risk hedging by the bank, external risk hedging by the bank, and the bank's on-balance-sheet equity capital.

Internal risk hedging can be achieved in many ways. Interest rate risk, for example, can be hedged internally through continual duration management or by matching the maturities of a like amount of assets and liabilities. Also, a diversified portfolio of assets is a hedge in its own right because a portfolio of assets will fluctuate much less in value than many of the assets in that portfolio, particularly those assets of a long-term or high-risk nature that are quite volatile over time.

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[57] Robert B. Avery and Terrence M. Belton, "A Comparison of Risk-Based Capital and Risk-Based Deposit Insurance," Economic Review, Federal Reserve Bank of Cleveland, 1987 Quarter 4, pp. 20-30.

External hedging occurs when a third party is paid to assume a specific risk. Interest rate swaps are an example of external hedging.

On-balance-sheet equity capital is available in a hedging context to absorb losses that are within the guaranteed bank and that are not absorbed by internal or external hedges.

Thus, the purpose of the financial risk component of the risk-sensitive premium is to compensate guarantors for the bank's exposure to financial risk that is not reasonably contained by the bank's internal and external risk hedging and by its own on-balance-sheet equity capital.

Essentially, the financial risk assessment process will determine the probability that the bank will fail and the magnitude of loss if the bank fails. This calculation will be based on the likely volatility of a future change in the market value of the bank's assets and liabilities. Since a bank's equity capital is affected by changes in the value of the bank's assets and liabilities, the bank's equity capital in the future will be affected by the volatility of changes in the value of its assets and liabilities. In effect, the likely future volatility of a bank's equity capital reflects the net effect of the volatility in the value of its various assets and liabilities. If a bank is not adequately capitalized for this volatility, then there is some probability that the bank will fail.

Volatility measures used to estimate both the probability of failure and the magnitude of the bank's loss to its guarantors will reflect marketplace conditions beyond the control of any bank, the banking system, or the federal government. These volatility measures include interest rate swings, price level changes, business cycle activity, foreign exchange fluctuations, innovations, etc. In effect, this probability calculation will be a stress test for the bank to determine how well it can survive difficult financial conditions. Since price deflation is much more of a bank killer than price inflation, specific factors used in the probability calculation will include the impact of price level declines on the different types of collateral securing the guaranteed bank's loans.

The actual formula used to calculate the probability of failure most likely will be a regression model into which will be plugged various measures of volatility, with each measure assigned a pre-determined weight. Several different economic scenarios (such as interest rates rise 200 basis points over the next six months, economic activity declines 3% in real economic activity over the next year; asset prices decline 10%, etc.) will then be run through the regression model. Each different run of the model will generate a probability that the bank will fail under that particular economic scenario. The three or five highest probabilities of failure might then be averaged to determine a composite probability of failure that will be used in the pricing formula. The likely insolvency loss associated with each of the highest probabilities will also be averaged to determine the likely magnitude of loss if the bank failed. Multiplying the composite probability of failure times the average magnitude of loss will give the expected rate of loss for the guaranteed bank.

This periodic determination of the probability of failure may resemble the option pricing system that the Chicago Mercantile Exchange uses to periodically adjust margin requirements for its members.

Because future change in value is the fundamental issue in risk-sensitive pricing, the departure point for this calculation probably will be the current risk-adjusted market value of the bank's assets and liabilities, and thus its net worth. How current market values will be estimated is discussed below.

The time period over which the impact of future volatility will be assessed under the risk-sensitive pricing formula most likely will be 6 to 12 months. This time is sufficient to allow a bank to reduce its portfolio risk or to bring its equity capital position in balance with its portfolio risk by raising fresh capital. If necessary, this time frame also will give a syndicate of guarantors sufficient opportunity to cancel its cross-guarantee contract with the guaranteed bank before the bank actually fails. Cancellation is discussed in Box 11.

By frequently calculating, possibly as often as weekly or biweekly, a guaranteed bank's probability of failure and the magnitude of its insolvency loss if failure occurs, the syndicate agent effectively will quantify the leading indicators of banking risk present in that bank. That is, frequently recalculating a bank's probability of failure will incorporate new portfolio risks shortly after they are assumed by the bank. The bank's cross-guarantee premium rate will be adjusted correspondingly. This frequent adjustment of the premium rate will encourage banks to make the premium rate an integral part of their cost of funds so that their risk-adjusted interest rate spread, net also of its cross-guarantee premium, will remain fairly constant.

The formula for calculating a bank's expected rate of loss and thus its risk-sensitive premium rate will be negotiated in advance by the guaranteed bank and the syndicate of guarantor banks and then incorporated in the cross-guarantee contract. The basis for negotiating the formula will be recent marketplace volatility, computer simulations, recent loss experience of guarantors, references to established pricing practices for cross-guarantees, and efforts by guaranteed banks to "game" those practices.

Market value accounting

Market value accounting will be an essential element in setting risk-sensitive premiums because it will be a very logical starting point in determining a bank's probability of failure.

Market value accounting will assess the current market value of both the bank's assets and liabilities on the basis of ground rules and procedures negotiated between the guaranteed bank and its cross-guarantee syndicate. The calculation of market value net worth will not be constricted by generally accepted accounting principles (GAAP), regulatory accounting practices (RAP), or any other external guidelines. The basis for making this calculation will be subject solely to the terms of the contract between the guaranteed bank and its cross-guarantee syndicate.

Periodically establishing the market value of a bank's assets and liabilities will not be as difficult as would first appear because it will not be necessary to precisely establish the value of every asset or liability in order to reasonably estimate the market value of the bank's net worth. Furthermore, not all assets have to be revalued at the same frequency or to the same degree of precision. For example, the value of assets for which there is an established secondary market (marketable securities, loans of many types, mortgage servicing, etc.) could be established easily and frequently.

Nonmarketable assets also could be valued, but perhaps not as frequently. Risk-adjusted income streams of loans, for example, can be capitalized at an appropriate spread over the Treasury yield curve. Fixed assets can be valued periodically through real estate appraisals and auction prices of furniture and equipment. Other assets, specifically intangibles, can be valued on the basis of appraisals, or the amortized cost basis of the asset can be used when the guaranteed bank and its cross-guarantee syndicate deem it appropriate.

The risk-adjusted market value of specific assets will then be determined by subtracting from the current market value of these assets the present value cost of hedges that have been purchased to reduce the risk of loss in the value of these assets.

Deposits and other liabilities will be valued on the basis of current interest rates after adjusting for early redemption provisions in deposit contracts. Since guarantors will be unlikely to actually liquidate a failed bank, it is appropriate to ignore the stated amount of those liabilities. It also will be legitimate to include in this computation a conservative valuation of the franchise or going-concern value of the bank's deposit base.

Additional financial risk factors

Cross-guarantee syndicates might wish to incorporate in the failure prediction formula some additional components of financial risk that cannot easily be priced for hedging purposes. These additional factors could include the following:

Growth rates Rapid growth in real or inflation-adjusted terms might be penalized though a higher premium rate because rapidly growing banks and thrifts are more likely than slower growing institutions to make mistakes that later cause losses. In particular, management resources are stretched thin and financial controls are more likely to break down in a rapidly growing bank than they will in a slowly growing bank. The premium formula could even assess and price several measures of growth, including assets on a real or inflation-adjusted basis, employees, transaction volume, or risk exposure.

Rapid growth in specific asset categories, even in a slowly growing bank, also might trigger a higher premium rate for the same reason: Rapid growth most likely will increase the losses that the bank eventually will experience in that asset category. For example, two banks are growing their total assets 5% annually in real terms; however, Bank A is growing its construction lending 50% annually while Bank B is growing its construction lending just 5% annually. Bank A should pay a higher premium rate than Bank B, all other things being equal.

Ratio of net operating expenses to total assets This ratio is an efficiency measure that identifies the ability of a bank to recover fee-related expenses with fee income. A low expense ratio means that the bank is well positioned to survive a decline in its net interest margin should that decline occur. More importantly, because operating efficiencies and adequate fee income cannot be achieved overnight, a rising ratio signals an adverse trend within the bank that could take several years to reverse. Thus, the premium rate should rise as this ratio rises.

Trend in the probability of failure The pricing formula could not only price on the basis of financial risk, but also on the trend or direction of this risk. All other factors being equal, an adverse trend should be more costly for a guaranteed bank than a favorable trend because an adverse trend increases the probability of failure. For example, a bank that has slowed its asset growth rate from 30% annually to 20% should pay a lower premium rate than a bank whose growth rate had gone from 15% annually to 20%. Or a bank whose risk-adjusted market value net worth rose from 2% to 2.5% might pay a lower premium rate than a bank where this percentage dropped from 3% to 2.5%.

The premium base for the 100% cross-guarantee premium

The premium base on which 100% cross-guarantee premiums will be charged probably will include all of the guaranteed bank's deposits (domestic and foreign) plus all of its other on-balance-sheet and off-balance-sheet liabilities. However, it is possible that the cross-guarantee marketplace might develop other bases against which to apply the premium rate.

Operations risk: procedural and internal control compliance

The failure probability calculation might also penalize a bank for failing to follow the bank's own procedures for assuming and managing banking risk. This penalty could be a multiplier of the probability of failure, or it might be a separate charge. Thus, of two banks with identical risk profiles, the one with sloppier operations should pay a higher premium rate because of the multiplier effect, or it might pay a separate charge for this risk.

This element of the pricing formula is based on the following observation: Banks and thrifts often get into financial difficulty because they have not followed their own essentially sound internal procedures. In effect, procedural and internal control breakdowns lead to mistakes that later cause losses in the value of specific assets.

Procedural and internal control monitoring differs from measuring financial risk in one important way: Procedural monitoring seeks to minimize individual or unique mistakes. Measuring financial risk attempts to quantify conditions and trends that could lead to numerous specific losses (such as a concentration of loan losses in Texas real estate).

Measuring procedural and internal control compliance will complement the measurement of financial risk and, in fact, both of these aspects of the pricing formula might detect the same problem. For example, a rapid growth in an uncovered foreign exchange position might result from a breakdown in the approval process for entering foreign exchange contracts.

Procedural compliance will not necessarily require material qualitative judgments. Instead, it will penalize a bank for not following its own procedures for assuming and managing risk. Pricing to encourage procedural compliance will not guarantee that the managers of the guaranteed bank will make the right decisions, but at least this aspect of risk-sensitive pricing will encourage decisions to be made through predetermined channels and processes. Penalizing poor procedures should lessen the probability of failure for most guaranteed banks.

The balance between objective and judgmental measures of procedural risk will be struck in the cross-guarantee marketplace. Thus, cross-guarantee contracts will delineate the specific procedural conditions on which each contract's pricing formula is based.

Specific types of procedures that could be monitored could include credit approvals, loan processing, investment approvals, exception approvals, error rates in transactions processing, risk exposure management, asset reviews, delinquent loan follow-up, flow of funds and computer system controls, and internal auditing procedures. For example, incompletely documented loans or loans made before the appropriate credit approvals were obtained could be procedural violations. For high-volume activities, such as auto, credit card, and home loans, sampling techniques probably would be used to assess procedural compliance. Large transactions might receive a 100% review. Significantly different procedures will not have to be implemented to make procedural monitoring work as guarantors generally will be satisfied if the guaranteed bank's own procedures actually are followed.

Procedural compliance under the cross-guarantee concept will differ from traditional government bank examination in two ways. First, guarantor monitoring will be continuous and nearly real time (i.e., problems and procedural breakdowns will quickly be identified). Second, violations caught by guarantor monitoring will cost the bank money, not regulatory knuckle-rapping or cease-and-desist-orders, which is usually the case with violations uncovered during a government bank examination.

Perhaps the most salutary effect of procedural compliance monitoring will be to keep a bank's internal auditors and financial controllers on their toes since cross-guarantee premiums paid because of procedural shortcomings will reflect badly on the bank's internal audit and financial control personnel. In one sense, procedural compliance monitoring will monitor the adequacy of a bank's internal audit and financial control functions.

Serious procedural violations uncovered in the monitoring process will be reported to the syndicate agent and possibly to the management of the guaranteed bank. Procedural problems of an extremely serious nature might even lead the syndicate to cancel the cross-guarantee contract.

Premium pricing will not be excessively complicated

Pricing 100% cross-guarantee premiums will be less complicated than it might seem for the following reasons:

During the first three to five years after cross-guarantees become effective, failure prediction techniques will undergo rapid development since there is a tremendous untapped potential to enhance these techniques, specifically by applying some of the quantitative techniques now being used elsewhere in the financial services industry to define, measure, and unbundle banking risk. After this start-up period, though, changes in failure prediction and pricing techniques probably will be evolutionary. These changes will be driven by changes in the organization, products, and information systems of the guaranteed banks and new developments in financial technology relating to the risk assessment process.

Further simplifying the pricing process is the likelihood that the pricing methodology will be substantially the same in all cross-guarantee contracts. For example, guarantors probably will use similar procedures to estimate the unhedged risks of foreign exchange trading at Bankers Trust as they will use at Chase Manhattan. This similarity will occur because the substantial overlap of guarantors among all banks will insure that an innovation in one cross-guarantee contract will quickly spread to all other cross-guarantee contracts once that innovation had proven itself. In other words, there will be few pricing secrets in the cross-guarantee world.

The risk monitoring process

The monitoring of a guaranteed bank will be performed by employees of the syndicate agent. Under no circumstances will monitoring personnel be employees of the guarantor banks. This prohibition will help greatly to maintain the confidentiality of competitively sensitive data and other information about the guaranteed bank that the guarantor banks do not need to know, except possibly when the guaranteed bank is in dire straits.

Field monitoring personnel will divide their time between data verification and procedural compliance work. Data verification work will consist of testing the accuracy of data being drawn from the bank's information systems for input into the cross-guarantee pricing formula. Much of this testing will involve tracing specific transactions through the bank's computer and paperwork systems to determine that the data output from these systems is reliable. Procedural compliance work will involve reviewing documents and computerized approval systems to insure that pre-established procedures are being followed properly.

In larger banks (several billion dollars or more in assets), the agent's monitoring personnel will work full time at that bank, but not for it. The syndicate agent guaranteeing a $4 billion bank, for example, might assign five or six employees fulltime to perform monitoring work at that bank. Monitoring personnel, however, will not work continuously at smaller banks. Instead, one or a few employees of the syndicate agent will make frequent visits to the smaller banks, each time verifying data and procedures in a different area of the bank. For example, one employee of the syndicate agent might spend one week per month monitoring activities at a bank with $100 million in assets.

The syndicate agent will have to have great latitude as to what and how often it monitors specific activities, provided the data and procedures that are monitored properly lie within the scope of the cross-guarantee contract. Particular emphasis will be placed on monitoring those areas of the bank where the pricing formula is signaling high and/or rapidly changing risk volatility or where a computerized surveillance system detects data inconsistencies that warrant field checking. These techniques will enable the agent to identify potential problems in the bank that should be of concern to its guarantors. Monitoring personnel also will be expected to report to their supervisors any adverse conditions of a qualitative nature that they detect within a guaranteed bank. Syndicate members also should be expected to report confidentially to the agent on adverse trends in the guaranteed bank that they detect in the banking marketplace.

Premium payments and monitoring fees

The syndicate agent will calculate and collect both the cross-guarantee premium and the monitoring fee. The cross-guarantee premium will be transmitted immediately to the guarantor banks while the syndicate agent will retain the monitoring fee to cover its expenses.

The monitoring fee will be based on the assets of the guaranteed bank or some proxy for assets that also include claims that the guaranteed bank has on third parties by virtue of the commitments the bank has entered (letters of credit, swaps, futures, options, etc.). The author's research indicates that for most banks, the monitoring fee will be in the range of 2 basis points (.02%) of total assets and possibly less for large wholesale banks. However, the rate for the monitoring fee will rise as a bank sinks into marginal condition, or worse. This higher fee will compensate the agent for having to monitor the bank more intensely, specifically in more closely assessing the market value of the bank's assets. Smaller banks also will have to pay a somewhat higher monitoring fee because there will be diseconomies of scale in underwriting their cross-guarantee risk and in the on-site monitoring of their activities. However, the lower operating costs and greater operational freedom that smaller banks will enjoy under the 100% cross-guarantee concept will more than offset these moderately higher monitoring costs.

The anticipated breakdown of the syndicate agent's expenses is as follows: risk underwriting and syndication expense = 20% to 30%; on-site monitoring expense = 50% to 60%; and general and marketing expenses = 20%. The syndicate agent might earn some of its profit by sharing in that portion of the loss premium that is paid to syndicate members and that is not consumed by actual losses. This feature will parallel the syndicate agent's interest with the syndicate's members to whom the agent owes a fiduciary duty. Like most aspects of the cross-guarantee concept, though, any such profit sharing will be negotiated in the cross-guarantee marketplace.

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

TUESDAY, MAY 22, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met, pursuant to notice, at 9:58 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Dixon, D'Amato, and Graham.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

Let me welcome all those in attendance this morning, and let me particularly welcome the witnesses today, who I will introduce just a little bit later.

Our hearing this morning is on the issue of deposit insurance reform, and it is part of the series of hearings that we are having this year to examine that question and the related question of possible change in the activities that banks should be allowed to take part in our financial system.

Ten years ago the Federal deposit insurance concept and system was widely admired for stabilizing our financial system at what seemed to be no cost to the taxpayer. The prevailing view over that period was that this stability was beneficial directly to the banks and their depositors, but that it also promoted our overall economic prosperity and stability as a country. Everyone came out ahead, or so it seemed.

In the past decade, however, the picture has been changing. Banks and thrift failures have become more numerous and much more expensive. The insolvency of the Federal Savings and Loan Insurance Corporation has been really a catastrophic failure of enormous size.

Critics have even criticized the stabilizing role of deposit insurance. They assert that deposit insurance as it currently operates promotes excessive risk taking and thus contributes in various ways to instability.

So we want to determine whether the current structure of Federal deposit insurance is flawed and, if so, what should we do about it. Should we, for example, seek to build more market discipline into the system and, if so, who should we rely on to provide that discipline.

We have of course some major studies that are now underway within the Government that we will have available to us early next year, that together with these hearings and other analytic work, will provide the foundation for any changes that we determine that we need to make in this area.

So we very much look forward to exploring these issues with our distinguished panel of witnesses this morning, and I will introduce them after Senator Garn has made his opening comments.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

I note you started early. I was not late. I would like everybody to know that. It is just 10 o'clock now.

The CHAIRMAN. All right.

Senator GARN. I thought maybe you were trying to confuse me. [Laughter.]

Mr. Chairman, I commend you for assembling another distinguished panel of experts to help us devise the best model for our financial system, although I admit that after all these years of talking about this, it's very difficult to think of anything new to say about hearings on deposit insurance. I am hoping that we hear something new from you gentlemen this morning.

Our country certainly has reached a critical juncture in a world of increasing global competition for financial services. We accustomed ourselves to a position of preeminence in the banking world, and yet over the past decade this position has been challenged by Western Europe and by Asia, specifically Japan.

Moreover, we have just suffered the greatest domestic banking crisis since the 1930's. We now face the crucial test of whether to restructure in a way that reinforces our strengths and avoids the pitfalls of the past, or to muddle through in our current fragmented and inefficient financial system or, worse yet, attempt to reconstruct a simpler and long-departed financial world.

The decade of the 1990's may be our last opportunity to make the choices that will help ensure our position in the financial world. We count on experts such as those assembled here today to help us redesign our financial system.

Gentlemen, I thank you for your appearance here today and look forward to your testimony.

The CHAIRMAN. Thank you, Senator Garn.

Our three witnesses today will be Mr. James Barth, who was the Lowder Eminent Scholar in Finance at Auburn University, and formerly the Chief Economist at the Office of Thrift Supervision; Mr. Lowell Bryan, who is the Director of McKinsey and Company in New York City; and Mr. George C. Kaufman, who is the John F. Smith Jr. Professor of Economics and Finance at Loyola University of Chicago.

We are very pleased to have each of you with us today, and I might also that we will make your full statements a part of the record, and we would like any summary comments that go right to the most important points that you want to share with us.

I would ask you, that to the extent that you have any concern about the current strength of the BIF Fund under the FDIC that you talk about that and share with us any concerns you might have in that are.

Mr. Barth, we are pleased to start with you today.

STATEMENT OF JAMES R. BARTH, LOWDER EMINENT SCHOLAR IN FINANCE, AUBURN UNIVERSITY, AUBURN, AL

Mr. Barth. Thank you.

My name is James R. Barth, and I am a Professor of Finance at Auburn University.

Thank you, Mr. Chairman, for the invitation to appear before the committee today to discuss problems with the current structure of the Federal Deposit Insurance System and potential reform to correct those problems. The committee is to be commended for holding hearings on such an important issue.

Some may question the need to reform Federal Deposit Insurance System. After all, the insurance system was established to protect small depositors against loss and to prevent the payment system from collapse by providing sufficient depositor confidence that widespread runs on depositor institutions would be eliminated. These two goals have been accomplished.

But there is a third goal that has been all too often overlooked. The Federal insurance system was also established to protect taxpayers. It is the failure to accomplish this third goal, as evidenced by the enormous cost to resolve the thrift crisis, that explains why the current structure, the Federal Deposit Insurance System needs to be reformed. Without reform, taxpayers cannot be assured that they will never again be called upon to share in excessive costs to resolve troubled depository institutions.

The reason I believe the current structure of the Federal Deposit Insurance System needs to be reformed is based upon a fairly detailed analysis of the causes of the thrift crisis.

As the attached paper included as part of my testimony indicates, which I co-authored with Dr. Phillip Bartholomew of the Congressional Budget Office, and which I draw upon heavily in this testimony, a relatively unique set of circumstances gave rise to the thrift crisis of the 1980's. Most people are quite familiar with those causes, and therefore I do not wish to restate them here today.

But I do wish to point out that despite all the causes, it is my view that the major culprit in the thrift crisis is Federal deposit insurance. Other factors, such as deregulation and fraud, only exacerbated the problem. They were not fundamental causes of the problem.

The scope of the crisis was highly magnified by the way the Federal Deposit Insurance System was structured, and there are three crucial parts to this structure: one, capital, two, information, and three, a reorganization or closure rule. These three parts are meant to create proper incentives and impose discipline.

First, as regards capital. As Richard Pratt, a former Chairman of the Federal Home Loan Bank Board, has recently testified before the Congress, "by 1982 the real capital positions of all thrift institutions have been completely eroded and virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates."

However, insolvent or institutions without capital were not reorganized or closed in a timely and cost effective manner. Yet, these are the very institutions that have little, if anything, to lose by raising their rates to attract more insured deposits with which to invest in those activities promising the highest returns, and I emphasize the word "promising." It is the heads I win, tails Federal insurer looses scenario.

Interestingly enough, when the Federal Deposit Insurance System was being established in the 1930's, it was widely known at that time that "the possibility of losing owner's capital is without doubt the strongest force in operation to prevent unsound banking." Such a setting, moreover, was conducive to more fraud and abuse than would have otherwise occurred.

As William Black, a current official of the Office of Thrift Supervision, has recently stated, "with no money of their own at risk, the incentive to engage in fraud proved compelling for many thrifts."

Furthermore, most of the deregulation that many blame for the thrift crisis came after, and I underline the word "after," the thrift industry was in deep trouble.

It is instructive to note that in the early 1800's the ratio of capital to assets for banks was around 60 percent, and then drifted downward thereafter.

In the early 1900's it was around 20 percent, and then declined to 13 percent or so in the 1920's just before the Great Depression.

After the establishment of Federal deposit insurance and despite the accompanying moral hazard problem, capital to asset ratios nonetheless declined to about 6 percent by 1980. Interestingly enough, in 1939 the Federal Deposit Insurance Corporation stated in its annual report that, and I quote:

> The corporation's policy with regard to capital would be to urge each bank to maintain a minimum capital account equal to at least 10 percent of the appraised value of its assets.

Both bank and thrift capital standards are not only less than 10 percent, but also based upon historic or book rather than the appraised or estimated market value of assets.

Second, as regards information. One must be clear about the way in which capital is measured. Even Richard Pratt, a former Chairman of the Federal Home Loan Bank Board, stated in 1983 that, and I quote:

> The management accounting information now being generated within institutions and reported to the Federal Home Loan Bank Board and other supervisors is generally obsolete. Because historical generally accepted accounting principles fail to account for the real changes in the performance of financial institutions, it may lead to managerial behavior which seeks a certain historical cost accounting result, but which actually damages both the institution, the insurance corporation and the regulator.

It should be noted that the same comments, and I provide them in my statement, were made by a regulator in the 1930's, that is, regarding the inadequacy of financial reports being filed.

Third, as regards a reorganization or closure rule, more than 50 years ago when Federal deposit insurance was being established it was stated that, and I quote:

> With the establishment of Federal deposit insurance, the task of preventing banks from developing an unsound or embarrassed condition looms larger than ever before among the duties of the supervisory and examining authorities. They should, therefore, be given adequate powers and be required to make full and effective use of them in order that an incipient, unhealthy condition may be immediately corrected and that uneconomic banks may be closed before they reach a state where liquidation would involve losses.

This statement is as true today as it was when it was made in 1935. It is a call for an early reorganization or closure rule. Yet, hundreds of thrift institutions were not resolved in a timely or cost effective manner.

One is clearly engaged in a balancing act when trying to structure Federal deposit insurance properly. The goals are to prevent widespread runs, to protect small depositors and to protect taxpayers. By preventing runs, one guarantees depositors from loss, but exposes taxpayers to excessive losses. These losses result from inadequately containing the excessively risky actions taken by institutions that are induced by moral hazard.

Adequate capital and appropriate information are crucial in this balancing act, as I have indicated in my previous statements. Even with adequate capital standards and appropriate information being collected, however, one cannot be sure that the Federal insurer will abide by an early reorganization or closure rule when institutions become troubled. That was clearly the case for thrift institutions in the 1980s.

To be sure that the Federal insurer will indeed act in a timely and cost effective manner requires more market discipline. The major disagreement is over how to achieve such discipline.

All the proposals for reforming the structure of the Federal Deposit Insurance System involve the collection and assessment of market-based information, the reliance on an adequate level of capital and the reorganization or closure of inadequately capitalized institutions in a timely and cost effective manner. The disagreement is over who does or sees to it that these things are done. If one cannot obtain good information for a broad range of assets, the narrow bank proposal or modification thereof is quite attractive and, indeed, it is intellectually very appealing.

If one can obtain enough information to both set appropriate insurance premiums and implement a proper reorganization or closure rule based upon that information, then the Government and private firms, either independently or cooperatively, can operate an insurance plan. If the Federal insurer cannot act upon the available information in an appropriate manner, then one would want heavy, if not exclusive, private sector involvement.

If the capital of the private sector is insufficient to prevent widespread runs, one would want heavy, if not exclusive, Federal sector involvement.

In sum, there is a consensus that reform at least means that capital must be adequate to provide an incentive for insured depository institutions not to engage in excessively risky activities. This is the major lesson from the thrift crisis. As capital declines, the risk of loss is clearly sifted from the owners to the depositors, and if insured to the insurer, and if exclusively a Federal insurer the taxpayer.

To contain this risk shifting behavior, somebody must impose discipline by attempting to measure capital correctly and then, if it declines, by intervening in a timely and cost effective manner. This intervention will necessarily take the form of requiring that more capital be injected or control of the institution be taken away from the current owners.

Whether the private sector or the Government can best impose this discipline is an area of disagreement. Some joint sharing of this responsibility may be best, especially given the need to proceed with caution in the current financial environment.

At present, and I will underline "at present," I do not favor the cross-guarantee proposal or the narrow bank proposal despite its considerable appeal. I favor retaining Federal deposit insurance, but moving towards more market discipline by requiring more capital, more use of market value information, use of and not just solely reliance upon market value information for obvious reasons in terms of measurement, and believe that coinsurance or reinsurance should be seriously and carefully studied so as to provide an independent set of risk assessments to ensure timely reorganization or closure.

The key is to restructure the Federal Deposit Insurance System so as to permit evolution in the depository institutions industry while simultaneously identifying, managing and funding any troubled institutions in a timely and cost effective manner. This is an extremely complex and difficult task.

Furthermore, this task must not be considered in isolation. One must also consider the appropriate regulatory structure in any restructured insurance system as well as the overall effect and the long-run values of the charters for those depository institution one wants to exist.

Our insured depository institutions today are clearly in trouble. One might note that in the 1940's commercial banks, the major insured depository institutions, held roughly 60 percent of all the assets of all financial service firms. Today they only hold about 30 percent. That tells us something about where capital is going. It's going into other financial service firms.

With that I will stop for now, and thank you very much.

The CHAIRMAN. Thank you very much, and we appreciate the depth and thoroughness of the presentation that you have prepared for us today.

[The complete statement of James R. Barth follows:]

Statement of

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on the subject of

Deposit Insurance Reform

before the

Committee on Banking, Housing,
and Urban Affairs

United States Senate

May 22, 1990

Deposit Insurance Reform

Summary

I believe that the current structure of the federal deposit insurance system needs to be reformed. Some, however, may question the need for reform. After all, the insurance system was established to protect small depositors against loss and to prevent the payments system from collapse by providing sufficient depositor confidence that widespread runs on depository institutions would be eliminated. These two goals have been accomplished. But there is a third goal that has been all too often overlooked. The federal insurance system was also established to protect taxpayers. It is the failure to accomplish this third goal, as evidenced by the enormous cost to resolve the thrift crisis, that explains why the current structure of the federal deposit insurance system needs to be reformed. Without reform, taxpayers cannot be assured that they will never again be called upon to share in excessive costs to resolve troubled depository institutions.

Based upon a fairly detailed analysis of the causes of the thrift crisis, it is my view that the major culprit in the thrift crisis is federal deposit insurance. Other factors such as deregulation and fraud certainly contributed to failures and the cost of resolving those failures. But the scope of the crisis was magnified by the way the federal insurance system was structured.

The appropriate response to deterioration in the financial condition of thrift institutions is to impose discipline on seriously troubled institutions, which includes closing such institutions in a timely and cost-effective manner. Yet, this was not done to the degree required during the 1980s. Institutions were insolvent for quite lengthy periods of time before being closed. Only with federal deposit insurance could such seriously troubled institutions remain open for so long and obtain the funds with which to gamble for resurrection.

Inadequately capitalized institutions that are left open have every incentive to bid up rates on deposits so as to attract funds to engage in excessively risky activities in an attempt to overcome their difficulties. Many troubled institutions pursued just such a strategy and not surprisingly only exacerbated an already serious situation.

More than fifty years ago, when federal deposit insurance was being established, it was stated that

> With the establishment of federal deposit insurance, "the task of preventing banks from developing an unsound or embarrassed condition looms larger than ever before among

> the duties of the supervisory and examining authorities. They should, therefore, be given adequate powers, and be required to make full and effective use of them, in order that an incipient unhealthy condition may be immediately corrected, and that uneconomic banks may be closed before they reach a state where liquidation would involve losses."

This statement is as true today as it was when it was made in 1935. It is a call for an early reorganization or closure rule.

Clearly, for adequately capitalized institutions, there is essentially no moral hazard problem and thus no need to enforce an early reorganization or closure rule. Capital provides not only a proper incentive for the owners to contain risk-taking behavior but also protects others from losses. There appears to be universal agreement that thrift institutions were permitted to operate with too little capital in the 1980s. But how much capital should thrift and other federally insured depository institutions be required to hold?

It is instructive to note that in the early 1800s the ratio of capital-to-assets for banks was around 60 percent and then drifted downward thereafter. In the early 1900s it was around 20 percent, and then declined to 13 percent or so in the 1920s. After the establishment of deposit insurance and despite the accompanying moral hazard problem, capital-to-asset ratios nonetheless declined to about 6 percent by 1980. Interestingly enough, in 1939 the Federal Deposit Insurance Corporation stated in its annual report that "the Corporations policy with regard to capital would be to urge each bank to maintain a minimum capital account equal to at least 10% of the appraised value of its assets." Both bank and thrift capital standards are not only substantially less than 10 percent but also based upon historic or book rather than the appraised or market value of assets.

One is clearly engaged in a balancing act when trying to structure federal deposit insurance properly. The goals are to prevent widespread runs, to protect small depositors and to protect taxpayers. By preventing runs one guarantees depositors from loss but exposes taxpayers to excessive losses. These losses result from inadequately containing the excessively risky actions taken by institutions that are induced by moral hazard, or, more generally, the non-cost-effective actions taken by the federal insurer to resolve troubled institutions. Adequate capital and appropriate information are crucial in this balancing act.

To be sure that the federal insurer will indeed act in a timely and cost-effective manner requires more market discipline. The major disagreement is over how to achieve such discipline.

All the proposals for reforming the structure of the federal deposit insurance system involve the collection and assessment of market-based information, the reliance on an adequate level of capital, and the reorganization or closure of inadequately capitalized depository institutions in a timely and cost-effective manner. The disagreement is over who does or sees to it that these things are done. If one cannot obtain good information for a broad range of assets, the narrow bank proposal or a modification thereof is quite attractive. If one can obtain enough information to both set appropriate insurance premiums and implement a proper reorganization or closure rule based upon that information, then the government and private firms, either independently or cooperatively, can operate an insurance plan. If the federal insurer will or can not act upon the available information in an appropriate manner, then one would want heavy, if not exclusive, private sector involvement. If the capital of the private sector is insufficient to prevent widespread runs, one would want heavy, if not exclusive, federal sector involvement.

In sum, the major culprit in the thrift crisis is the current structure of the federal deposit insurance system. Only by reforming this system, can taxpayers be assured that they will not be called upon again to share in excessive losses. But how should the deposit insurance system be reformed? The easy answer is to rely more on market discipline. What this really means is subject to disagreement, however. Despite this, there is a consensus that it at least means that capital must be adequate to provide an incentive for insured depository institutions not to engage in excessively risky activities. This is the major lesson from the thrift crisis. As capital declines the risk of loss is clearly shifted from the owners to the depositors and, if insured, to the insurer and, if exclusively a federal insurer, the taxpayer. To contain this risk-shifting behavior, somebody must impose discipline by attempting to measure capital correctly and then if it declines by intervening in a timely and cost-effective manner. This intervention will necessarily take the form of requiring that more capital be injected or control of the institution be taken away from the current owners. Whether the private sector or the government can best impose this discipline is an area of disagreement. Some joint sharing of this responsibility may be best, especially given the need to proceed with caution in the current financial environment.

The key is to restructure the federal deposit insurance system so as to permit evolution in the depository institutions industry while simultaneously identifying, managing and funding any troubled institutions in a timely and cost-effective manner. This is an extremely complex and difficult task. Furthermore, this task must not be considered in isolation. One must also consider the appropriate regulatory structure in any restructured insurance system as well as the overall effect on the long-run values of the charters for those depository institutions one wants to exist.

Thank you, Mr. Chairman, for the invitation to appear before the Committee today to discuss problems with the current structure of the federal deposit insurance system and potential reforms to correct those problems. The Committee is to be commended for holding hearings on such an important issue. Some may question the need to reform the federal deposit insurance system. After all, the insurance system was established to protect small depositors against loss and to prevent the payments system from collapse by providing sufficient depositor confidence that widespread runs on depository institutions would be eliminated. These two goals have been accomplished. But there is a third goal that has been all too often overlooked. The federal insurance system was also established to protect taxpayers. It is the failure to accomplish this third goal, as evidenced by the enormous cost to resolve the thrift crisis, that explains why the current structure of the federal deposit insurance system needs to be reformed. Without reform, taxpayers cannot be assured that they will never again be called upon to share in excessive costs to resolve troubled depository institutions.

What Caused the Thrift Crisis?

The reason I believe that the current structure of the federal deposit insurance system needs to be reformed is based upon a fairly detailed analysis of the causes of the thrift crisis. As the attached paper to my testimony indicates (which I co-authored with Dr. Philip F. Bartholomew of the Congressional Budget Office and upon which I draw heavily in this testimony), a relatively unique set of circumstances gave rise to the thrift crisis of the 1980s. First, interest rates rose to unexpectedly high levels in the late 1970s and early 1980s and have remained quite volatile since then. This exogenous shock to the financial markets followed a change in operating procedures by the Federal Reserve in October 1979. Second, thrift institutions were required by laws and regulations over a period of decades to operate on the basis of gathering deposits at variable rates and lending those funds for home purchases at fixed rates. The higher rates in the late 1970s and early 1980s drove up deposit costs without a corresponding increase in revenues from mortgage loans. As a result, the fundamental flaw in the design of the thrift industry, that many had for years been advocating be reformed, was finally and openly exposed. Profits vanished and capital -- regardless as to how measured -- was seriously eroded. Indeed, 85 percent of all thrift institutions lost money in 1981 and tangible capital declined to only 0.6 percent of assets in 1982 from 3.9 percent in 1981. Third, the interest rate problems were followed almost immediately by a deterioration in the quality of assets as regional economies experienced difficulties, particularly in the Southwest. Thrift institutions reported steadily increasing nonoperating losses from 1986 onward, reaching a record $15.4 billion in 1989. Fourth, state and federal authorities provided thrifts with greater asset and liability powers and phased-out ceilings on the rates that could be offered on deposits over the period 1980 to 1986. For adequately capitalized institutions this meant an opportunity for greater diversification and ability to compete in an increasingly competitive financial market-place. For inadequately capitalized institutions, on the other hand, this meant more degrees of freedom with respect to risk-taking, especially when provided with access to funds insured up to $100,000 per account rather than only $40,000 as was in effect before the major turmoil that began in the 1980s. Fifth, substantial improvements in informational technology, rapid growth in asset securitization, and greater overall competition among financial service firms in the 1980s significantly narrowed the net interest margins for thrift institutions. Sixth, the Tax Reform Act of 1986 reduced the depreciation benefits from investing in commercial and residential property, limited the offsetting losses on passive investments that affects limited partnership syndications, and eliminated the favorable capital gains treatment. These changes in the tax laws adversely affected real estate values and thereby thrift institutions. Seventh, fraud and insider abuse, not to mention mismanagement, are always a concern, especially during a period of turbulence and lax supervision and regulation. Eighth, and most important, the structure of the federal deposit insurance system creates a moral hazard problem, whereby an insured institution has an incentive to engage in riskier behavior than otherwise. By inadequately containing this proclivity toward risk, losses at insured depository institutions can become excessive and taxpayers therefore required to help absorb them.

Did the Federal Insurer Adequately Contain the Incentive to Adopt a High-Risk Strategy by Thrift Institutions?

It is my view that the major culprit in the thrift crisis is federal deposit insurance. Other factors such as deregulation and fraud certainly contributed to failures and the cost of resolving those failures. But the scope of the crisis was magnified by the way the federal insurance system was structured. As evidence for this statement, consider what happened when thrifts experienced huge losses and significant erosion in their capital in the early 1980s. Capital requirements were lowered and the measure of regulatory capital (RAP capital) that was relied upon to close troubled institutions was broadened to include items not even counted under generally accepted accounting principles (GAAP). As a result, the divergence between alternative book-value measures of capital increased dramatically. In 1982, the RAP capital-to-asset ratio was 3.8 percent, the GAAP capital-to-asset ratio was 2.9 percent, and the tangible capital-to-asset ratio was only 0.6 percent. Worse yet, all three measures actually overstated the financial condition of the thrift industry. For, as Richard Pratt, a former Chairman of the Federal Home Loan Bank Board, has recently testified before the Congress, "By 1982, the real capital positions of all thrift institutions had been completely eroded, and virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates." Indeed, when one adjusts for interest rate effects, the market value of thrift capital relative to assets was a negative 14.4 percent in 1982.

The important point about the increased divergence in the alternative measures of capital in the early 1980s is that with the stroke of the regulatory pen many seriously troubled institutions were immediately restored to regulatory solvency rather than reorganized or closed (that is, liquidated or sold). Yet, these are the very institutions that have little, if anything, to lose by raising their rates to attract more insured deposits with which to invest in those activities promising the highest returns. It is the "heads I win, tails federal insurer loses" scenario. Interestingly enough, even when the federal deposit insurance system was being established in the 1930s it was widely known that "The possibility of losing owners' capital is, without doubt, the strongest force in operation to prevent unsound banking." Such a setting, moreover, was conducive to more fraud and abuse than would have otherwise occurred. As William Black, a current official of the Office of Thrift Supervision, has recently stated: "With no money of their own at risk, the incentive to...engage in fraud proved compelling for many thrifts." Furthermore, most of the deregulation that many blame for the thrift crisis came after the thrift industry was in deep trouble

The appropriate response to deterioration in the financial condition of thrift institutions is to impose discipline on seriously troubled institutions, which includes closing such institutions in a timely and cost-effective manner. Yet, this was not done to the degree required during the 1980s. Institutions resolved during the 1980s had been insolvent on a tangible (TAP) basis for quite lengthy periods of time before being closed. Indeed, in 1988 the 205 thrift institutions that were resolved at an estimated present-value cost of $31.8 billion had been insolvent on average for three and one-half years. This means that these institutions had no reported tangible capital as far back as 1984 or 1985. On the basis of estimated market values, taking account of interest rate changes, they were insolvent even years earlier. Only with federal deposit insurance could such seriously troubled institutions remain open for so long and obtain the funds with which to gamble for resurrection.

Inadequately capitalized institutions that are left open have every incentive to bid up rates on deposits so as to attract funds to engage in excessively risky activities in an attempt to overcome their difficulties. Many troubled institutions pursued just such a strategy and not surprisingly only exacerbated an already serious situation. Broader asset powers, deposit rate deregulation, and greater deposit insurance coverage only gave these institutions more degrees of freedom in their end-game strategies. Even fraud and abuse were more likely to flourish in an environment in which institutions remained open while insolvent.

Lenient regulatory capital requirements coupled with federal deposit insurance create not only a moral hazard problem, but also an adverse selection problem, whereby those most likely to impose costs upon the insurer seek the benefits of insurance. Unless the regulator intervenes in a timely manner, inadequately capitalized institutions can engage in excessively risky activities funded with insured deposits, which clearly leads to even bigger costs being borne by the federal insurer when such institutions are eventually closed. All the data in the attached paper attest to this fact.

How Should the Federal Deposit Insurance System Be Reformed?

More than fifty years ago, when federal deposit insurance was being established, it was stated that

> With the establishment of federal deposit insurance, "the task of preventing banks from developing an unsound or embarrassed condition looms larger than ever before among the duties of the supervisory and examining authorities. They should, therefore, be given adequate powers, and be required to make full and effective use of them, in order that an incipient unhealthy condition may be immediately corrected, and that uneconomic banks may be closed before they reach a state where liquidation would involve losses."

This statement is as true today as it was when it was made in 1935. It is a call for an early reorganization or closure rule.

Clearly, for adequately capitalized institutions, there is essentially no moral hazard problem and thus no need to enforce an early reorganization or closure rule. Capital provides not only a proper incentive for the owners to contain risk-taking behavior but also protects others from losses. There appears to be universal agreement that thrift institutions were permitted to operate with too little capital in the 1980s. But how much capital should thrift and other federally insured depository institutions be required to hold?

It is instructive to note that in the early 1800s the ratio of capital-to-assets for banks was around 60 percent and then drifted downward thereafter. In the early 1900s it was around 20 percent, and then declined to 13 percent or so in the 1920s. After the establishment of deposit insurance and despite the accompanying moral hazard problem, capital-to-asset ratios nonetheless declined to about 6 percent by 1980. All these ratios, moreover, were based upon tangible measures of capital. The Financial Institutions, Reform, Recovery and Enforcement Act of 1989, however, only imposes an initial tangible capital requirement of 1.5 percent for thrift institutions, but which rises to 3 percent in 1995. Interestingly enough, in 1939 the Federal Deposit Insurance Corporation stated in its annual report that "the Corporations policy with regard to capital would be to urge each bank to maintain a minimum capital account equal to at least 10% of the appraised value of its assets." Both bank and thrift capital standards are not only less than 10 percent but also based upon historic or book rather than the appraised or market value of assets.

Beyond requiring adequate capital for depository institutions, one must be clear about the way in which it is measured. Even Richard Pratt, a former Chairman of the Federal Home Loan Bank Board, stated in 1983 that "The management and accounting information now being generated within institutions and reported to the Federal Home Loan Bank Board and other supervisors is generally obsolete. Because historical generally accepted accounting principles (GAAP) fail to account for the real changes in the performance of financial institutions, it may lead to managerial behavior which seeks a certain historical cost accounting result but which actually damages both the institution, the insurance corporation, and the regulator."

For purposes of comparison, it should be noted that during the financial and economic collapse of the 1930s the first Chairman of the Federal Deposit Insurance Corporation when asked about the informational content of the reports filed by banks stated that "You take the old condensed statements gotten out by national banks and state banks for years; they did not show the market value of their bonds or the reasonable value of their loans." Under such circumstances is it surprising that depositors were unsure about the financial condition of banks and therefore engaged in widespread runs on them?

Of course, if one could assess the market value of all the assets and liabilities of a bank or thrift, one could then determine whether the institution was solvent or insolvent. Indeed, based upon such information one could close an institution exactly when the market value of capital was zero. However, market values are not readily available for all assets and liabilities. This means that such values are necessarily estimates and hence imprecise. Despite this, one can require that an institution hold "adequate" capital relative to its assets to protect taxpayers and to provide an incentive for the institution to engage in less risky activities. For clearly the riskiest activities are likely to be undertaken by those institutions with inadequate capital and access to federal deposit insurance. One could therefore collect the best available market-value information and then use that information to reorganize or otherwise take appropriate action against an institution when its capital is being dissipated or depleted.

One is clearly engaged in a balancing act when trying to structure federal deposit insurance properly. The goals are to prevent widespread runs, to protect small depositors and to protect taxpayers. By preventing runs one guarantees depositors from loss but exposes taxpayers to excessive losses. These losses result from inadequately containing the excessively risky actions taken by institutions that are induced by moral hazard, or, more generally, the non-cost-effective actions taken by the federal insurer to resolve troubled institutions. Adequate capital and appropriate information are crucial in this balancing act.

Even with adequate capital standards and appropriate information being collected, however, one cannot be sure that the federal insurer will abide by an early reorganization or closure rule when institutions become troubled. In the case of the thrift crisis, institutions not only were inadequately capitalized but for years were reporting to the insurer that they were actually insolvent. One did not need market-value estimates to assess the depth of the problems at hundreds of institutions. They were reporting negative tangible capital for years, which even the insurer knew was an underestimate of the problem. It therefore may not be sufficient to reform the federal deposit insurance system by simply requiring relatively high capital standards and by placing greater reliance on market-value information.

To be sure that the federal insurer will indeed act in a timely and cost-effective manner requires more market discipline. The major disagreement is over how to achieve such discipline.

One proposal is to retain federal deposit insurance but to introduce coinsurance, at least above a minimum level, or reduce the amount of deposit insurance coverage, either per account or per depositor. By exposing depositors to more risk, they will demand higher rates on their funds placed at those banks engaged in relatively risky activities and with relatively little capital. This imposes discipline on banks operating in a competitive market. The insurer can rely upon the rates paid on uninsured deposits or any other uninsured liabilities, moreover, to enable it to better assess the financial condition of an institution based upon this market-value information. Although an appealing proposal, the risk of a widespread run does increase as compared to the current federal insurance system. But the amount by which the risk increases will depend upon the extent to which depositors are exposed to loss.

Another proposal for reform relies upon market discipline, but in a different way. This is the proposal for cross-guarantees by banks themselves or self-insurance. Banks would establish a fairly elaborate system under which the entire capital of the banking system would be available to cover losses from insolvencies. By charging appropriate premiums to one another, the banks themselves would provide the mechanism to induce banks to control their risk exposure through the type and degree of activities in which they engage or a high capital position. In the case of abnormal or catastrophic losses, the federal government or taxpayers would serve as a backstop to the banks. Three potential limitations of this proposal are: 1) depositors may engage in widespread runs for fear that the combined capital of the banks is insufficient to protect them, 2) the banks themselves will have an incentive to overstate any losses -- the opposite of what troubled thrift institutions had an incentive to do -- to protect their capital from being depleted and thus put pressure on the federal government to step forward prematurely and share in the losses, and 3) it is not clear how this system will ensure that troubled institutions will be reorganized or closed in a timely and cost-effective manner.

To the extent the federal government will always be in the picture, it may make sense to define the role of the federal government more clearly and thus make it more susceptible to public scrutiny. One way to do this is to rely upon a form of reinsurance in which the federal insurer would assume some relatively high percentage of all losses from insolvencies of depository institutions and the reinsurer the remaining percentage. The reinsurer would be responsible for assessing the overall riskiness of a depository institution and determining an appropriate insurance premium. The federal insurer could then, if it wished, apply this premium to all insured deposits. The merit of this particular proposal is that not only is there no risk of widespread runs but also that specialized private firms would be assessing the financial condition of insured depository institutions. By putting their own capital at risk, they would have every incentive to collect and assess the most appropriate financial information by which to set an appropriate deposit insurance premium. More generally, such firms would establish contractual relationships with depository institutions that would provide market-based information to the federal insurer and the public that would more likely insure that inadequately capitalized institutions were reorganized or closed in a timely and cost-effective manner. As Ken Scott and Thomas Mayer said in a seminal paper on deposit insurance years ago, "This is probably the most promising solution. Part, if not all, of the pricing judgement could be transferred to the private sector... . The resulting demand would bring a new form of deposit insurance into existence and thereby create a large, independent set of risk judgements."

Finally, one could simply reform the federal deposit insurance system by requiring that all deposits be backed or collateralized by highly marketable and essentially riskless assets. This would protect the payments system from widespread runs because depositors would know that the market value of the assets would essentially always equal the value of deposits. This narrowing of the assets that could be acquired converts the current commercial bank into a narrow bank. The narrowness of the bank depends upon the assets acquired with the insured deposits, which in turn depends on the availability of accurate financial information regarding the market value of specific assets. Under this proposal, all remaining assets of the bank would be funded with uninsured liabilities and capital.

This narrow bank proposal accomplishes the following goals. First, it protects small depositors. Second, it prevents widespread bank runs by backing deposits with assets whose market value equals those deposits. Third, it protects taxpayers from losses arising from declines in asset values below the value of insured deposits plus uninsured liabilities plus capital because in essence there will be no such declines. Fourth, while the narrow or payments portion of the bank is fully protected against loss, the remaining or credit portion is not. However, any losses associated with the credit portion are borne by the owners of the uninsured liabilities and capital, not taxpayers. Fifth, such a system actually makes deposit insurance redundant and the need for bank activity regulation relatively unimportant. This proposal is based upon the premise that market-value information for a broad range of assets is unavailable or too imprecise or that the insurer will not act in a timely and cost-effective manner based upon such information.

In sum, all the proposals for reforming the structure of the federal deposit insurance system involve the collection and assessment of market-based information, the reliance on an adequate level of capital, and the reorganization or closure of inadequately capitalized depository institutions in a timely and cost-effective manner. The disagreement is over who does or sees to it that these things are done. If one cannot obtain good information for a broad range of assets, the narrow bank proposal or a modification thereof is quite attractive. If one can obtain enough information to both set appropriate insurance premiums and implement a proper reorganization or closure rule based upon that information, then the government and private firms, either independently or cooperatively, can operate an insurance plan. If the federal insurer will or can not act upon the available information in an appropriate manner, then one would want heavy, if not exclusive, private sector involvement. If the capital of the private sector is insufficient to prevent widespread runs, one would want heavy, if not exclusive, federal sector involvement.

Furthermore, regardless of which, if any, reform proposal is adopted, no bank should be considered to be too big to fail. The only issue is how one manages the failure. Market discipline requires that all banks be resolved in the same manner. The bigger the troubled institution, however, the more crucial knowledgeable personnel become to reorganize or close the institution in a timely and cost-effective manner and the more important the Federal Reserve becomes to respond to any international and liquidity issues. Holding companies, moreover, should not be an unlimited source of strength. Limited liability is a way to attract capital to depository institutions. But the entire investment of a holding company in a bank or thrift should be fully at risk.

Summary and Conclusions

It has been argued here that the major culprit in the thrift crisis is the current structure of the federal deposit insurance system. Only by reforming this system, can taxpayers be assured that they will not be called upon again to share in excessive losses. But how should the deposit insurance system be reformed? The easy answer is to rely more on market discipline. What this really means is subject to disagreement, however. Despite this, there is a consensus that it at least means that capital must be adequate to provide an incentive for insured depository institutions not to engage in excessively risky activities. This is the major lesson from the thrift crisis. As capital declines the risk of loss is clearly shifted from the owners to the depositors and, if insured, to the insurer and, if exclusively a federal insurer, the taxpayer. To contain this risk-shifting behavior, somebody must impose discipline by attempting to measure capital correctly and then if it declines by intervening in a timely and cost-effective manner. This intervention will necessarily take the form of requiring that more capital be injected or control of the institution be taken away from the current owners. Whether the private sector or the government can best impose this discipline is an area of disagreement. Some joint sharing of this responsibility may be best, especially given the need to proceed with caution in the current financial environment.

The key is to restructure the federal deposit insurance system so as to permit evolution in the depository institutions industry while simultaneously identifying, managing and funding any troubled institutions in a timely and cost-effective manner. This is an extremely complex and difficult task. Furthermore, this task must not be considered in isolation. One must also consider the appropriate regulatory structure in any restructured insurance system as well as the overall effect on the long-run values of the charters for those depository institutions one wants to exist.

"The Thrift-Industry Crisis: Revealed Weaknesses in the Federal Deposit Insurance System"

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> With the establishment of federal deposit insurance, "the task of preventing banks from developing an unsound or embarrassed condition looms larger than ever before among the duties of the supervisory and examining authorities. They should, therefore, be given adequate powers, and be required to make full and effective use of them, in order that an incipient unhealthy condition may be immediately corrected, and that uneconomic banks may be closed before they reach a state where liquidation would involve losses" (Bremer, 1935, p. 140).

The thrift industry has just completed the worst decade in its 160 year existence. More than 500 institutions were closed at an estimated present-value cost in excess of $50 billion. Despite all these closures, still another 500 or more institutions were open but insolvent at the end of the decade. These remaining candidates for closure will cost an estimated $100 billion or more (see Barth and Brumbaugh, 1990). There are hundreds more thrift institutions that are financially weak and attempting to survive the massive consolidation, shrinkage, and restructuring that is sweeping through the industry.

Shortly after taking office, President Bush proposed legislation to resolve the crisis in the thrift industry once and for all. Although the Congress was asked to take action within 45 days, it was not until August 9th that the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) was signed into law (for a

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chronology, see Table 1). Perhaps the most important feature of this legislation was the recognition by both the Administration and the Congress that the problem was so severe that taxpayer dollars were required to make whole all insured deposits at troubled thrift institutions. The most serious shortcoming, on the other hand, was the failure to adequately restructure the federal deposit insurance system. Yet, as will be argued here, the major culprit in the thrift crisis is the current structure of the insurance system.

What Happened and What Will Be the Cost?

The thrift industry was ravished by all the adverse developments that occurred during the 1980s. Table 2 shows that there were 3,993 thrifts in 1980, whereas there were only 2,878 by 1989. And 281 of these were in conservatorship. This 28 percent decline includes 525 institutions that were closed (that is, liquidated, sold, or stabilized) at an estimated present-value cost of $54 billion.

Despite the tremendous decline in the number of thrifts and all the closings, there were still insolvent institutions open at yearend 1989. Indeed, as Table 2 shows, there were 517 tangible insolvent institutions with $283 billion in assets. Furthermore, 122 thrifts with $60 billion in assets had a tangible capital-to-assets ratio less than one and one-half percent.

The cost of resolving all the seriously troubled thrift institutions has been a source of considerable controversy, ever since the first such estimate was published in the mid-1980s (see Barth, Brumbaugh, Sauerhaft, and Wang, 1985). As Chart 1 shows, all the cost estimates have increased over time, but the official estimates have always been substantially below private-sector estimates. The most recent cost estimates of resolving all remaining seriously troubled institutions substantially exceed the $50 billion provided by FIRREA. Table 3 shows that such estimates range from $75-80 billion to at least $325 billion.

What Caused the Thrift Crisis?

As many have observed (see, for example, Barth, Bartholomew, and Labich, 1989), a relatively unique set of circumstances gave rise to the thrift crisis of the 1980s. First, interest rates rose to unexpectedly high levels in the early 1980s and have remained quite volatile since then. This development followed a change in operating procedures by the Federal Reserve in October 1979. Second, thrift institutions were required by law and regulation to operate on the basis of gathering deposits at variable rates and lending those funds for home purchases at fixed rates. The higher rates in the early 1980s drove up deposit costs without a corresponding increase in revenues from mortgage loans. As a result, the fundamental flaw in the design of the thrift industry was finally and openly exposed. Profits vanished and capital -- regardless as to how measured -- was seriously eroded. Indeed, 85 percent of all savings and loans lost money in 1981 and, as Table 2 shows, tangible capital declined to only $4 billion in 1982 from $25 billion in 1981. Third, the interest rate problems were followed almost immediately by a deterioration in the quality of assets as regional economies experienced serious difficulties, particularly in the Southwest. Thrift institutions reported steadily increasing nonoperating losses from 1986 onward, reaching a record $15.4 billion in 1989 (see Table 2). Fourth, state and federal authorities provided thrifts with greater asset and liability powers and phased-out ceilings on deposit rates over the period 1980 to 1986. For adequately capitalized institutions this meant an opportunity for greater diversification. For inadequately capitalized institutions, on the other hand, this meant more degrees of freedom with respect to risk-taking. Fifth, substantial improvements in informational technology, rapid growth in asset securitization, and greater overall competition among financial service firms in the 1980s significantly narrowed the net interest margins for thrift institutions. Sixth, the Tax Reform Act of 1986 reduced the depreciation benefits from investing in commercial and residential property, limited the offsetting losses on passive investments that affects limited partnership syndications, and eliminated the favorable capital gains treatment. These changes in tax laws adversely affected real estate values and thereby thrift institutions. Seventh, fraud and insider abuse, not to mention mismanagement, are always a concern, especially during a period of turbulence and lax supervision and regulation. Eighth, and most important, the structure of the federal deposit insurance system creates a moral hazard problem, whereby an insured institution has an incentive to engage in riskier behavior than otherwise.

What is the Incentive to Adopt a High-Risk Strategy?

As stated at the outset, it is our view that the major culprit in the thrift crisis is federal deposit insurance. Other factors such as deregulation and fraud certainly contributed to failures and the cost of resolving those failures. But the scope of the crisis was magnified by the way the federal insurance system was structured. The insurance system was established to protect small depositors against loss and to protect the payments system from collapse by providing sufficient depositor confidence that widespread runs on depository institutions would be eliminated. It accomplished these two objectives. But it has not adequately protected taxpayers, despite the fact that "With deposit insurance..., the chief function of government supervision and examination...seems to be to prevent undue risk from falling upon the government and its agencies" (Jones, 1940, p. 192).

Chart 2 shows that when thrifts experienced huge losses and significant erosion in their capital in the early 1980s, the response of the Congress and the thrift regulator was to lower capital requirements and to broaden the measure of regulatory capital (RAP capital) that was relied upon to close troubled institutions to include items not even counted under generally accepted accounting principles (GAAP). As a result, the divergence between alternative book-value measures of capital increased dramatically. In 1982, as Table 4 shows, the RAP capital-to-asset ratio was 3.8 percent, the GAAP capital-to-asset ratio was 2.9 percent, and the tangible capital-to-asset ratio was only 0.6 percent. Worse yet, all three measures actually overstated the financial condition of the thrift industry. For, as a former Chairman of the Federal Home Loan Bank Board has recently testified, "By 1982, the real capital positions of all thrift institutions had been completely eroded, and virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates" (Pratt, 1988, p. 4). Indeed, when one adjusts for interest rate effects, the market value of thrift capital relative to assets was a negative 14.4 percent in 1982 (see Table 4). This means, as was pointed out in a major book on the thrift crisis in the early 1980s, "The evolution of the industry over the next few years has therefore been largely predetermined, and only the accounting rules that emphasize historical costs have prevented a widespread realization of this fact. It will become increasingly apparent that many firma cannot survive unassisted" (Carron, 1982, p. 84).

The important point about the increased divergence in the alternative measures of capital is that with the stroke of the regulatory pen many seriously troubled institutions were immediately restored to regulatory solvency rather than closed (that is, liquidated, sold, or stabilized). Yet, these are the very institutions that have little, if anything, to lose by raising their rates to attract more insured deposits with which to invest in those activities promising the highest returns. It is the "heads I win, tails federal insurer loses" scenario. Interestingly enough, even when the federal deposit insurance system was being established it was widely known that "The possibility of losing owners' capital is, without doubt, the strongest force in operation to prevent unsound banking" (Taggart and Jennings, 1934, pp. 514-515). Such a setting, moreover, was conducive to more fraud and abuse than would have otherwise occurred. As a current official of the Office of Thrift Supervision has recently stated: "With no money of their own at risk, the incentive to...engage in fraud proved compelling for many thrifts" (Black, 1989, p. 27).

A response of capital leniency on the part of the Congress and thrift regulator to trouble in the thrift industry was not unprecedented. As reported in an official publication of the Federal Home Loan Bank Board, "From 1961 to 1971, economic conditions were generally cited as the reason behind a number of liberalizing amendments [to the capital requirements]" (Rochester, 1979, p. 6). Not surprisingly, the economic conditions included narrowing yield spreads and volatile interest rates.

How Did the Government Respond to the Turmoil?

The government did indeed respond to the turmoil in the thrift industry. Prior to FIRREA, the Congress passed the Depository Institutions Deregulation and Monetary Control Act in 1980, the Garn-St Germain Depository Institutions Act in 1982, and the Competitive Equality Banking Act in 1987. But, as already noted, this legislation permitted the lowering of capital requirements. It also increased the availability of federal deposit insurance to $100,000 from $40,000 per account. The legislation also provided for greater asset and liability powers to thrift institutions and deregulated the rates that could be offered on deposits. Without appropriate risk-based premiums or risk-based capital requirements, however, the burden for curtailing risk or imposing discipline had to be borne almost entirely by the federal insurer. Such discipline is admittedly extremely difficult to impose in an environment in which thousands of institutions are losing money and experiencing capital depletion. But that is the very time that discipline is most urgently needed.

The appropriate governmental response to deterioration in the financial condition of thrift institutions is to impose discipline on seriously troubled institutions, which includes closing such institutions in a timely and cost-effective manner. Yet, this was not done to the degree required during the 1980s. As Tables 5 and 6 indicate, institutions resolved during the 1980s had been insolvent on a tangible (TAP) basis for quite lengthy periods of time before being closed. Indeed, in 1988 the 205 thrift institutions that were resolved at an estimated present-value cost of $31.8 billion had been insolvent on average for three and one-half years. This means that these institutions had no reported tangible capital as far back as 1984 or 1985. On the basis of market values, they were insolvent even years earlier. Only with federal deposit insurance could such seriously troubled institutions remain open for so long and obtain the funds with which to gamble for resurrection.

Troubled institutions that are left open have every incentive to bid up rates on deposits so as to attract funds to engage in excessively risky activities in an attempt to overcome their difficulties. Many troubled institutions pursued just such a strategy and not surprisingly only exacerbated on already serious situation. Broader asset powers, deposit rate deregulation, and greater deposit insurance coverage only gave these institutions more degrees of freedom in their end-game strategies. Even fraud and abuse were more likely to flourish in an environment in which institutions remained open while insolvent (See Table 7).

Tables 8 and 9 present selected information on the characteristics of the 205 thrift institutions that were closed in 1988. Cursory evidence indicates that the cost of resolution is directly related to the length of insolvency, the ownership form, and in the case of stock form, the dispersion of stock ownership. Lamar Savings Association, for example, was a closely-held stock-type institution that grew at an average rate of 63 percent during the 1983-1985 period. As it grew, it also increasingly shifted its portfolio heavily towards high-risk investments. Although resolved in 1988, the state-chartered institution was insolvent on a tangible basis at least six years earlier.

Clearly, lenient regulatory capital requirements coupled with federal deposit insurance create not only a moral hazard problem, but also an adverse selection problem, whereby those most likely to impose costs upon the insurer seek the benefits of insurance. Unless the regulator intervenes in a timely manner (one institution was first insolvent 90 months prior to resolution), inadequately capitalized institutions can engage in excessively risky activities funded with insured deposits, which almost always leads to even bigger costs being borne by the federal insurer when such institutions are eventually closed. The data in Tables 8 and 9 attest to this fact.

Does FIRREA Resolve the Thrift Crisis Once and For All?

FIRREA mandates a number of changes in an attempt to resolve the thrift crisis and to ensure that a similar situation never again occurs (for more detail, see Barth, Benston, and Wiest, 1990). Among some of the important changes are the following:

o Regulatory Structure-The Office of Thrift Supervision (OTS) was created as a new bureau in the Department of Treasury to regulate, examine, and supervise all thrift institutions. Insurance for thrifts is provided by the Savings Association Insurance Fund (SAIF), while insurance for commercial banks is provided by the Bank Insurance Fund (BIF). Both are administered by the Federal Deposit Insurance Corporation (FDIC). The Resolution Trust Corporation (RTC) was created to resolve all insolvent thrifts turned over to it by the OTS after January 1, 1989 and for three years from the date of enactment of FIRREA. The RTC is overseen by the RTC Oversight Board which has five members, including the Treasury Secretary, Federal Reserve Chairman, HUD Secretary, and two independent members. The FSLIC Resolution Fund was created to handle all resolutions prior to January 1, 1989. The Federal Housing Finance Board was created as an independent agency to oversee the Federal Home Loan Banks.

o Funding - $50 billion is provided to resolve all insolvent thrift institutions. It is obtained from the insurance premiums paid by thrifts, the retained earnings from and assessments levied on Federal Home Loan Banks, and taxpayers.

o Capital Requirements - Thrift institutions are subject to new and more stringent capital requirements. A risk-based capital requirement may be imposed by OTS, but it must be no less stringent than the one applicable to national banks. There is a leverage ratio that requires core capital to be not less than three percent of assets, and a minimum tangible capital-to-assets ratio of one and one-half percent. Core capital may include supervisory goodwill, but it will be phased-out by January 1, 1995.

o Insurance Premiums - Insurance premiums for thrifts and commercial banks are increased. Institutions insured by SAIF currently are assessed 0.208 percent of total deposits. This assessment will increase to 0.23 percent from January 1, 1991 through December 31, 1993, and then decrease to 0.18 from January 1, 1994 through December 31, 1997. The assessment rate will be 0.15 percent thereafter. BIF institutions are currently assessed at a rate of 0.12 percent of total domestic deposits. As of January 1, 1991 and beyond, this rate will increase to 0.15 percent. Under certain conditions, the premiums may be increased to a maximum assessment rate of 0.325 percent at a maximum year-to-year increase of 0.075 percent.

o Enforcement - Enforcement powers are considerably enhanced, including civil money penalties of up to $1,000,000 per day.

o Qualified Thrift Lender Test - Beginning July 1, 1991 all thrifts must meet a 70 percent qualified thrift lender test. Institutions failing the test lose their right to Federal Home Loan Bank advances and must either limit their new activities and new branches to those permitted a national bank or convert to a bank charter.

o Asset and Liability Powers - The asset and liability powers of thrifts are generally curtailed. Holdings of junk bonds by all institutions must be divested no later than July 1, 1994. All thrifts are also restricted to allocating only 15 rather than 100 percent of their capital to loans-to-one borrower. For federally chartered thrifts, commercial real estate loans may not exceed 400 percent of capital, whereas the previous limitation was 40 percent of assets. For state-chartered institutions, any institution that does not meet the fully phased-in capital requirement by January 1, 1990 will be limited to those activities authorized for federal thrift institutions. Furthermore, equity investments are prohibited unless authorized for federal institutions.

Overall, these and other provisions of FIRREA clearly lower the value of the thrift charter relative to those under which other depository institutions operate. The legislation means that the thrift industry will undergo major consolidation, shrinkage and restructuring for several years. It may even disappear as a separately chartered and regulated industry. But the important questions that remain are: Does FIRREA provide sufficient funds to resolve all the thrift insolvencies? Will the resolutions be done in a timely and cost-effective manner? And most importantly, does FIRREA address the fundamental cause of thrift crisis? Or could a similar situation occur again?

To answer these questions, one must consider the following. First, the legislation acknowledges that taxpayers will be required to share in the losses to resolve troubled thrift institutions. But their share will be larger than anticipated as all cost estimates now exceed the $50 billion provided by FIRREA. Regardless of the eventual cost, sufficient funds are needed to make up the difference between the value of the assets at troubled institutions and the insured deposits. This is true whether troubled institutions are liquidated or sold. Beyond providing limited funds and acknowledging taxpayers will share in the losses, FIRREA is basically silent about how to resolve troubled thrift institutions in a timely and cost-effective manner.

Second, the new regulatory structure generated some confusion as questions arose as to which agency is responsible for which set of issues. Checks and balances are fine so long as one can still identify the exact agency that is accountable for specific actions. Of course, one can question whether there is any longer a need for OTS, especially in view of all the consolidation and shrinkage occurring in the thrift industry and, as Tables 10, 11, and 12 show, its comparatively high cost of operation.

In any event, it is not yet clear who is ultimately responsible for being sure that troubled institutions will be reorganized or closed in a timely and cost-effective manner nor is it evident that FIRREA provides the incentives for the responsible party to engage in such behavior. Yet, these are extremely important issues, for as was pointed out in the early 1930s "If an insolvent bank is taken over promptly and its affairs administered by competent men, the loss to depositors may be greatly minimized. Otherwise, the yield from assets may be small and expenses large. There is considerable evidence of delays, inefficiency and political influence in this respect" (McCahan, 1931, p. 170).

Third, FIRREA does not correct the lack of diversification and maturity imbalance that has plagued the thrift industry. Indeed, the new and more stringent QTL test only compounds these problems. For as Carron and Brumbaugh (1990) have shown, traditional residential mortgage lending for thrift institutions has and is likely to remain unprofitable for the average institution.

Fourth, FIRREA does impose new and tougher capital requirements. However, as Chart 2 shows, these requirements are substantially lower than those in effect in 1980. Furthermore, they are based upon book-value measures of capital. Yet, as one of many individuals has pointed out, "Unless financial regulators begin to monitor and control leverage on the basis of market values, the question of asset deregulation is not fundamental. An insured institution can engage in risk-taking by leverage as well as by taking on asset risk" (Pyle, 1985, p. 724). In the case of thrift insolvencies, moreover, it was empirically determined several years ago "that the book-value measures of net worth systematically understated the cost to the FSLIC of resolving the failures" (Barth, Brumbaugh, and Sauerhaft, 1986, p. 12). Even a

Chairman of the Federal Home Loan Bank Board stated in the midst of the thrift crisis that "The management and accounting information now being generated within institutions and reported to the Federal Home Loan Bank Board and other supervisors is generally obsolete. Because historical generally accepted accounting principles (GAAP) fail to account for the real changes in the performance of financial institutions, it may lead to managerial behavior which seeks a certain historical cost accounting result but which actually damages both the institution, the insurance corporation, and the regulator" (Pratt, 1983, p. 4). For purpose of comparison, it should be noted that during the financial and economic collapse of the 1930s the first Chairman of the Federal Deposit Insurance Corporation when asked about the informational content of the reports filed by banks stated that "You take the old condensed statements gotten out by national banks and state banks for years; they did not show the market value of their bonds or the reasonable value of their loans" (Crowley, 1935, p. 97). Under such circumstances, is it surprising that depositors were unsure about the financial condition of banks and therefore engaged in widespread runs on them?

The important point is that appropriately measured capital is absolutely crucial for protecting taxpayers against losses. In this regard, it is instructive to note that, based upon information available for banks, "Early in the 1800's the ratio of capital to total assets ranged around 60% and drifted down steadily thereafter. By the early 1900's this ratio had fallen to about 20% and the rapid expansion of bank assets during World War I and the 1920's pulled it down below 13%" (Lindow, 1963, p. 30). In an attempt to reverse this downward trend, "The 1939 Annual Report of the FDIC stated that the Corporations policy with regard to capital would be to urge each bank to maintain a minimum capital account equal to at least 10% of the appraised value of its assets" (Ryon, 1969, p.7). Both bank and thrift capital standards currently are not only less than 10 percent but also based upon book rather than the appraised or market value of assets.

In sum, FIRREA does not adequately address the primary cause of the thrift crisis: the current structure of the federal deposit insurance system. Admittedly, by mandating a study of the federal insurance system, FIRREA acknowledges this limitation. But this does not alter the fact that the focus of the legislation gives the impression that fraud and deregulation were the main causes of all the problems in the thrift industry. Available evidence suggests otherwise. These factors exacerbated the problems, but certainly were not the fundamental causes.

What Lessons Can be Learned from Foreign Deposit Insurance Systems?

The United States is not the only country that has a system of federal deposit insurance. Indeed, at least 27 other countries guarantee deposits at financial institutions through a formal federal deposit insurance system (see Bartholomew and Vanderhoff, 1990, Bartholomew, 1989b, McCarthy, 1980, Pecchioli, 1987, Talley and Mas, 1989, and Woodward, 1989). All of the G-7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) currently have a system of federal deposit insurance. Furthermore, all the signatory nations of the Basle Accord on uniform capital requirements (the G-7 countries and Belgium, the Netherlands, Luxembourg, Sweden, and Switzerland) except Luxembourg have a formal system of deposit insurance.

However, as may be seen in Table 13, the foreign insurance systems were established fairly recently. The United States has the oldest operating federal deposit insurance system, but Czechoslovakia in 1924 was the first country to establish a national deposit insurance system (see McCarthy, 1980). It apparently ceased operations in 1938, however. The third country to establish federal deposit insurance was Cuba in 1952, a system designed to stem the flight of capital from Cuban banks to insured United States banks (See Talley and Mas, 1989). It is unclear what happened to this system after the revolution in 1958.

For the 32 separate insurance systems shown in Table 13 (Germany, like the United States, has separate funds for banks, thrifts, and credit unions), membership is strictly voluntary in nine countries. The remaining countries have compulsory membership for selected types of depositories, and in some cases permit other financial institutions to become members.

Deposit insurance systems in the different countries are administered in one of three ways. Fourteen of the systems are officially sponsored and administered directly by the federal government. The exact structure varies from one system to another. Some insurers are subordinate to another government agency, such as the Ministery or Department of Finance or the central bank, while others are considered to be autonomous. Still other foreign deposit insurance systems are either jointly administered through a public and private arrangement or administered through an industry arrangement.

Information on the coverage and premium structure of the foreign deposit insurance systems is presented in Table 14 (Bartholomew and Vanderhoff, 1990). Although both of these aspects of foreign deposit insurance systems vary considerably, some general observations may be made nonetheless. Most insurance systems have explicit limits on coverage, and only a few, albeit the more recent systems, have coinsurance. None of the systems has risk-based premiums, however. In fact, some of the systems do not even rely upon ex ante funding. Instead, they rely on ex post funding arrangements whereby assessments are made on members when losses are incurred. Even some of the insurance systems with ex ante funding arrangements, moreover, have resorted to ex post assessments when the reserve fund was seriously encumbered (see, for example, Corrigan, 1990).

A comparison of the types of coverage provided by foreign deposit insurance systems is presented in Table 15 (see Bartholomew and Vanderhoff, 1990). Unlike the United States, few countries extend coverage to interbank deposits. All countries, for which information was available, cover deposits held by nonresidents. However, only a few, including the United States, provide coverage of deposits denominated in foreign currencies. At least seven countries do not provide coverage for deposits in domestic branches of foreign banks. Yet, the United States and nine other countries do provide such coverage. Most countries do not provide coverage to depositors of overseas branches of domestic banks.

One must be careful in drawing conclusions about deposit insurance coverage. Many countries implicitly provide coverage of deposits either by not permitting some institutions to fail or by the method of resolving failed institutions. Indeed, some argue that the United States implicitly provides coverage of deposits in overseas branches and subsidiaries through a policy of too-big-to-fail (see Congressional Budget Office, 1990, pp. 249-250).

The United States has not been the only country that has had to deal with distressed financial institutions in recent years (see, for example, Cargill and Royama, 1988, Corrigan, 1990, Gilbody, Pecchioli, 1987, Woodward, 1989, and World Bank, 1989). Indeed, at least 25 countries have provided government assistance to distressed financial institutions in the past decade. Some of this assistance has been directly provided by a deposit insurance system, while some has taken the form of central bank assistance, industry assistance, or direct and indirect government assistance.

The Canada Deposit Insurance Corporation is still C$851 million in deficit as of year-end 1989 as a result of resolving 21 trust and loan and mortgage loan companies and two small regional chartered banks. Canadian bank regulators have also resorted to supervisory mergers and financial assistance to resolve several other regional chartered banks. In 1973, the United Kingdom provided liquidity, through the Bank of England and clearing banks, to keep a number of relatively small, unregulated secondary banks open. This action was taken prior to the establishment of bank deposit insurance in 1982. In 1984, the Bank of England resolved Johnson Matthey by selling it to an Australian bank. Norway resorted to direct government intervention when depressed oil prices posed serious problems to some of its banks in the early 1980s.

Between 1978 and 1983, Spain rescued 51 depositories that held 20 percent of all deposits. In 1965, the Bank of Japan provided assistance to prevent the closure of Yamaichi Securities, one of the then four largest securities companies in the country. In 1974, German authorities closed a medium-sized bank , which led to losses for some large depositors. In 1983, the German central bank persuaded other banks to assist a medium-sized bank until it could be sold to another institution. In 1988, the French government arranged the resolution of a small bank with some losses incurred by insured domestic depositors even though foreign depositors were compensated in full. In 1988, the newly established Italian deposit insurance fund resolved a large bank that the central bank had tried to rescue through capital injections.

There is relatively little evidence available thus far by which to evaluate the success of foreign deposit insurance systems. Some have disappeared or been restructured. The Canadian insurance system may have contributed to the prevention of bank runs. However, the response to an abnormal numbers of failures was a multiple-agency effort and included direct and indirect government assistance (see Bartholomew, 1989a). Apparently, none of the foreign deposit insurance systems has yet been required to deal with catastrophic losses. In this regard, the alternate structures of foreign insurance systems may be mainly interesting for their operating features. For example, the provision of coinsurance or an industry-funded arrangement may induce either depositors or other depositories to play a greater role in limiting risk. However, it is still too early to make such an assessment because the experience with these systems is limited, particularly in view of the fact that the overall regulatory environments within which financial institutions operate vary from one to another.

How Should the Federal Deposit Insurance System Be Reformed?

More than fifty years ago, when federal deposit insurance was being established, it was stated that:

> It [federal deposit insurance] will doubtless, as charged by its opponents, encourage unsound banking. The reckless banker will offer greater inducements to the public than the conservative banker, and as the public will realize that it is equally well protected in either institution, it will be attracted by the more liberal promises of the less sound bank. This will draw business away from the sound banks, and will increase the payments that the fund will be called on to make to reimburse depositors in failed banks. Careful, frequent and intelligent examinations and a viligant and strict supervision of insured banks will keep down losses. But whether they can be maintained in this character and whether they can hold losses down to a point that makes the continuance of the guaranty possible can be told only by putting the plan in actual operation (Malburn, 1934, p. 170).

Well, the insurance plan for thrift institutions was put into operation in 1934 and the expected losses at insolvent institutions resolved during the 1980s and the 1990s exceed those incurred by depositors of thrifts during the Great Depression.

It has been argued here that the reason for the current thrift crisis is the structure of the federal deposit insurance system. Before discussing how the system could be restructured, it may be instructive to recall that under the permanent deposit insurance plan of the Banking Act of 1933, deposits were to be insured (a) up to $10,000 in full, (b) 75 percent of the next $40,000, and (c) 50 percent of amounts over $50,000, and the funds for operating the plan were to be obtained by subscriptions to stock in the Federal Deposit Insurance Corporation by the Treasury, by the Federal Reserve System and by insured banks. Furthermore, repeated subscriptions to stock could be exacted from banks in times of stress. As has been noted, "The absence of any such reserve feature renders this a plan of mutual guaranty rather than insurance, "a plan that was "attacked vigorously" by the bankers (Emerson, 1934, p. 235). However, this plan was scrapped in favor of simply providing for full insurance of deposits up to $5,000 and a flat insurance premium of one-twelfth of 1 percent per annum to generate operating funds. Interestingly enough, there are calls today for reforming federal deposit insurance by introducing coinsurance and putting the capital of institutions between the insured depositors and taxpayers in the form of a mutual-or cross-guaranty system.

As regards the setting of the federal deposit insurance premium at one-twelfth of 1 percent, it is interesting to note how this particular figure was arrived at (for more detail on the origin and evolution of the coverage and premium structures for both banks and thrift institutions, see Barth, Fied, Riedel, and Tunis, 1989). In testimony before the House Committee on Banking and Currency, the first Chairman of the Federal Deposit Insurance Corporation, stated that "a premium at the rate of one-third of 1 percent of total deposits would have been necessary to cover all losses to depositors during the past 70 years. A premium at the rate of one-eighth of 1 percent would have covered depositors' losses in all years except those of severe depression." He added that "It is one-tenth of 1 percent for the deposits of $5,000 and under." Then why was the premium set at one-twelfth of 1 percent? According to the Chairman, "we do not believe that one-twelfth of 1 percent will build large enough reserves for the Deposit Insurance Corporation for the future, but the earning capacity of the banks right now is very low" (Crowley, 1935, pp. 10, 49, and

48, respectively). But what was to be done during a period in which abnormal or catastrophic losses swamped the insurance fund? The question was left unanswered.

One final historical note is that the federal government did not provide federal insurance for the first time in the 1930s. In fact, it provided insurance for postal savings deposits in 1910. During the Great Depression, this system provided a place for depositors to run with the funds they withdrew from banks and thrifts (see O'Hara and Easley, 1979). At the state level, moreover, several states established plans prior to the 1930s (see Calomiris, 1989 and Golembe, 1960).

In any event, it is time to return to the issue of reforming the structure of the federal deposit insurance system. The need to reform is based upon the view that although the insurance system protected the small depositor and prevented widespread runs in the 1980s it did not adequately protect the taxpayer. The cost of resolving insolvent thrift institutions escalated enormously when inadequately capitalized institutions were not closed in a timely and cost-effective manner. The rationale for reform is therefore based on the excessive costs imposed upon taxpayers by the existing structure of the federal deposit insurance system. By leaving this structure essentially intact, FIRREA does not ensure that such excessive costs will never again materialize.

The basic issues involved in deciding upon the appropriate role for the federal government with respect to depository institutions center around the availability of accurate financial information, the ability and willingness to act appropriately upon such information, and who shares in losses resulting from insolvencies. Without federal deposit insurance there is always the possibility that depositors will engage in widespread runs on banks, even solvent banks, and thereby disrupt the payments system and the credit process. The result will be not only insolvency losses, but excessive losses because even solvent banks will be driven into insolvency as they are forced to sell assets at fire-sale prices to meet the heavy deposit withdrawals. Of course, the losses would be shared by equity owners and depositors, not taxpayers. But the fundamental problem is that inadequate information prevents depositors from distinguishing the solvent from the insolvent banks. And should such a situation lead to widespread runs, taxpayers as well as bank owners and depositors would be seriously and adversely affected.

A lender-of-last resort, however, could supply liquidity to those banks incurring heavy deposit withdrawals but that are nonetheless solvent. Only the insolvent banks would then be forced to close by the heavy withdrawal of deposits. Yet, for the lender-of-last resort to function properly it, like a federal insurer, must have sufficient information to distinguish between solvent and insolvent banks and then the ability and willingness to act appropriately based upon that information.

Federal deposit insurance, on the other hand, removes the incentive for depositors to run on banks, both solvent and insolvent banks. It therefore protects small depositors and prevents runs, but simultaneously exposes taxpayers to losses. To protect them, the federal insurer must close all insolvent banks in a timely and cost-effective manner. Unless this is done the losses from insolvencies will necessarily be excessive and therefore potentially shared by taxpayers.

One is clearly engaged in a balancing act when trying to structure federal deposit insurance properly. The major goals are to prevent widespread runs and to protect taxpayers. By preventing runs one guarantees depositors from loss but exposes taxpayers to excessive losses. These losses result from inadequately containing the excessively risky actions taken by institutions that are induced by moral hazard and adverse selection or, more generally, and the non-cost-effective actions taken by the federal insurer to resolve troubled institutions. Information is crucial in this balancing act. If one can assess the market value of the assets and liabilities of a bank, then one can determine whether a depository institution is solvent or insolvent or, stated another way, adequately capitalized. To reduce the exposure of taxpayers to losses, one would simply assess the market value of an institution and then close the institution when the market value of the owner's contributed equity reached zero (see Brumbaugh, 1988 and Benston and Kaufman, 1988).

However, market values are not readily available for all assets and liabilities. This means that such values are necessarily estimates and hence imprecise. Despite this, one can require that an institution hold "adequate" capital relative to its assets to protect taxpayers as well as to provide an incentive for the institution to engage in less risky activities. For clearly the riskiest activities are likely to be undertaken by those institutions with inadequate capital and access to federal deposit insurance. The insurer could therefore collect the best available market-value information, base capital requirements on this information, and then close or otherwise take appropriate action against an institution when its capital has been seriously dissipated or depleted. This clearly was not done by the federal insurer of thrifts during the 1980s, especially the early 1980s, or even, for that matter, during the 1960s and the 1970s when the thrift industry also encountered significant difficulties. Indeed, a case can be made that the federal laws and regulations governing thrift institutions since the Great Depression has failed to adapt rapidly enough to evolving market forces and thereby increasingly exposed these institutions to greater risk which ironically enough was being inadequately contained by the federal insurer. Would such a flawed institutional design have arisen in a free market place (see, for example, Barth and Regalia, 1988)?

The role for deposit insurance premiums in such a reformed system is to reflect the fair value of the deposit insurance to an institution. The riskier the activities in which an institution engages and the weaker its capital position, the greater the value of deposit insurance to that institution and therefore the higher the premium should be. But adjusting deposit premiums upwards is no replacement for early intervention or closing an institution when its owner's contributed equity has been depleted. Indeed, in a recent paper, Barth, Page, and Whidbee (1990) show using option-pricing techniques that those thrift institutions that should have been assessed the highest premiums in the 1980s were actually operating without any owner contributed equity whatsoever.

One could simply reform the federal deposit insurance system by requiring that all deposits be backed or collateralized by highly marketable and essentially riskless assets. This would protect the payments system from widespread runs because depositors would know that the market value of the assets would essentially always equal the value of deposits. This limiting or narrowing of the assets that could be acquired converts the current commercial bank into a narrow bank (see Litan, 1987). The narrowness of the bank depends upon the assets acquired with the insured deposits, which in turn depends on the availability of accurate financial information regarding the market value of specific assets. Under this proposal, all remaining assets of the bank would be funded with uninsured liabilities and owner's contributed equity capital.

This narrow bank proposal accomplishes the following goals. First, it protects small depositors. Second, it prevents widespread bank runs by backing deposits with assets whose market value equals those deposits. Third, it protects taxpayers from losses arising from declines in asset values below the value of insured deposits plus uninsured liabilities plus owner's contributed equity capital because in essence there will be no such declines. Fourth, while the narrow or payments portion of the bank is fully protected against loss, the remaining or credit portion is not. However, any losses associated with the credit portion are borne by the owners of the uninsured liabilities and capital, not taxpayers. Fifth, such a system actually makes deposit insurance redundant and the need for bank activity regulation relatively unimportant. This proposal seems to be based upon the premise that market-value information for a broad range of assets is unavailable or too imprecise or that the insurer will not act in a timely and cost-effective manner based upon such information.

Another proposal is to retain federal deposit insurance but to impose more market discipline. This could be accomplished through coinsurance or by reducing the amount of deposit insurance coverage, either per account or per depositor. By exposing depositors to more risk, they will demand higher rates on their funds placed at those banks engaged in relatively risky activities and with relatively little capital. This imposes discipline on banks operating in a competitive market. The insurer can rely upon the rates paid on uninsured deposits or any other uninsured liabilities, moreover, to enable it to better assess the financial condition of an institution based upon this market-value information. However, the risk of a widespread run increases under this type of reform proposal as compared to the current federal insurance system.

Still another proposal for reform relies upon market discipline, but in a different way. This is the proposal for cross-guarantees by bank themselves or self-insurance (see Ely, 1989). Banks would establish a fairly elaborate system under which the entire capital of the banking system would be available to cover losses from insolvencies. By charging appropriate premiums to one another, the banks themselves would provide the mechanism to induce banks to control their risk exposure through the type and degree of activities in which they engage or a higher capital position. In the case of abnormal or catastrophic losses, the federal government or taxpayers would serve as a backstop to the banks. Two potential limitations of this proposal are: 1) depositors may engage in wide-spread runs for fear that the combined capital of the banks is insufficient to protect them, and 2) the banks themselves will have an incentive to overstate any losses--the opposite of what troubled thrift institutions had an incentive to do--to protect their capital from being depleted and thus put pressure on the federal government to step forward prematurely and share in the losses.

Finally, one could rely upon a form of reinsurance in which the federal insurer would assume some relatively high percentage of all losses from insolvencies of depository institutions and the reinsurer the remaining percentage. The reinsurer would be responsible for assessing the overall riskiness of a depository institution and determining an appropriate insurance premium. The federal insurer could then, if it wished, apply this premium to all insured deposits. The merit of this particular proposal is that specialized private firms would be assessing the financial condition of insured depository institutions. By putting their own capital at risk, they would have every incentive to collect and assess the most appropriate financial information by which to set a an appropriate deposit insurance premium. More generally, such firms would establish contractual relationships with depository institutions that would provide market-based information to the federal insurer and the public that would more likely insure that inadequately capitalized institutions were closed or reorganized in a timely and cost-effective manner. As Scott and Mayer said in a seminal paper on deposit insurance years ago, "This is probably the most promising solution. Part, if not all, of the pricing judgement could be transfered to the private sector... . The resulting demand would bring a new form of deposit insurance into existence and thereby create a large, independent set of risk judgements" (Scott and Mayer, 1971, p. 575).

In sum, all the proposals for reforming the structure of the federal deposit insurance system involve the collection and assessment of market-based information, the reliance on an adequate level of owner's equity capital, and the closure or reorganization of inadequately capitalized depository institutions in a timely and cost-effective manner. The disagreement is over who does or sees to it that these things are done. If one cannot obtain good information for a broad range of assets, the narrow bank proposal or a modification thereof is quite attractive. If one can obtain enough information to both set appropriate insurance premiums and cancel insurance based upon that information and still enable those firms both paying and receiving the premiums to earn an acceptable profit, then the government and private firms, either independently or cooperatively, can operate an insurance plan. If the federal insurer will or can not act upon the available information in an appropriate manner, then one would want heavy, if not exclusive, private sector involvement.

The basic question is: who can collect and assess the best information so as to determine with substantial precision the financial condition of depository institutions? The depositors themselves may not and thus engage in widespread runs on all depository institutions. A narrow bank solves this problem by providing depositors with sufficient information that they will not run. Federal deposit insurance also provides depositors with enough information that they will not run. The information is that the federal government has sufficient capital or taxing power to make whole all insured deposits. But the federal insurer may not adequately protect taxpayers by either not collecting and assessing the best information so as to determine the financial condition of depository institutions or not acting upon such information in a timely and cost-effective manner. In such a situation, the private sector can be exposed to greater risk or asked to assume greater risk and thereby assist the federal insurer by collecting and assesssing information and even setting deposit insurance premiums that reflect the overall riskiness of the activities in which depository institutions are engaged taking into account the owner's contributed equity capital. By putting more of its own capital at risk, the private sector will have every incentive to contain the riskiness of insured depository institutions. The greater the reliance on the private sector, however, the more concern that there will be about sufficiency of capital to prevent depositors from engaging in wide-spread runs. In any event, to the extent that the federal government will always be in the picture, it may make the most sense to investigate more closely proposals involving reinsurance or private firm risk-pricing schemes because of their information signalling usefulness. The role of the federal government would then be more clearly defined and thus susceptible to more public scrutiny.

Summary and Conclusions

It has been argued here that the major culprit in the thrift crisis is the current structure of the federal deposit insurance system. By failing to reform this system, FIRREA does not ensure that taxpayers will not be called upon again to share in excessive losses. But how should the deposit insurance system be reformed? The easy answer is to rely more on the private market place. What this really means is subject to disagreement, however. The key is to restructure the federal deposit insurance system so as to permit evolution in the depository institutions industry while simultaneously identifying, managing and funding any troubled institutions in a timely and cost-effective manner. Furthermore, this task must not be considered in isolation. This is an extremely complex and difficult task. One must also consider the appropriate regulatory structure in any restructured insurance system as well as the overall effect on the long-run values of the charters for those depository institutions one wants to exist.

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Table 1

CHRONOLOGY OF FIRREA

February 6th	President Bush announced his plan to resolve the crisis in the thrift industry and to place federal deposit insurance on a sound basis. As proposed, the plan would create and fund a new corporation to pay the cost of closing all insolvent thrift institutions, reorganize the regulatory structure of the thrift industry, and reform federal deposit insurance.
April 19th	The Senate approved its version of the thrift rescue and reform bill (S774) that was very close in spirit to the Administration's plan.
June 15th	The House adopted its version of the bill (HR 1278), including on budget financing, tough capital standards, and housing programs.
July 27th	Congressional conferees completed their work on the bill and agreed to put the $50 billion funding program on the federal budget while exempting the resulting three-year increase in the federal deficit from the Gramm-Rudman-anti-deficit law.
August 3d	President Bush wrote a letter to House GOP leader Robert Michel of Illinois, threatening to veto the bill if the funding program was placed on budget.
August 3d	Despite the veto threat, the House approved the conference report.
August 3d	The Senate turned down the conference report when it failed by a vote of 54 to 46 to achieve the three-fifth majority needed to grant the budget treatment an exemption from the Gramm-Rudman anti-deficit law. The bill was immediately returned to conference to resolve the only remaining point of contention--the financing plan.
August 4th	The Senate accepted the revised conference report that placed $20 billion on budget in 1989 and $30 billion off budget in fiscal years 1990 and 1991.
August 5th	The House accepted the revised conference report with the House leadership placing many of the proxy votes for members that had begun the summer recess.
August 9th	President Bush signed FIRREA into law.

Source: Office of Thrift Supervision.

Table 2
Thrift Industry: 1980-1989

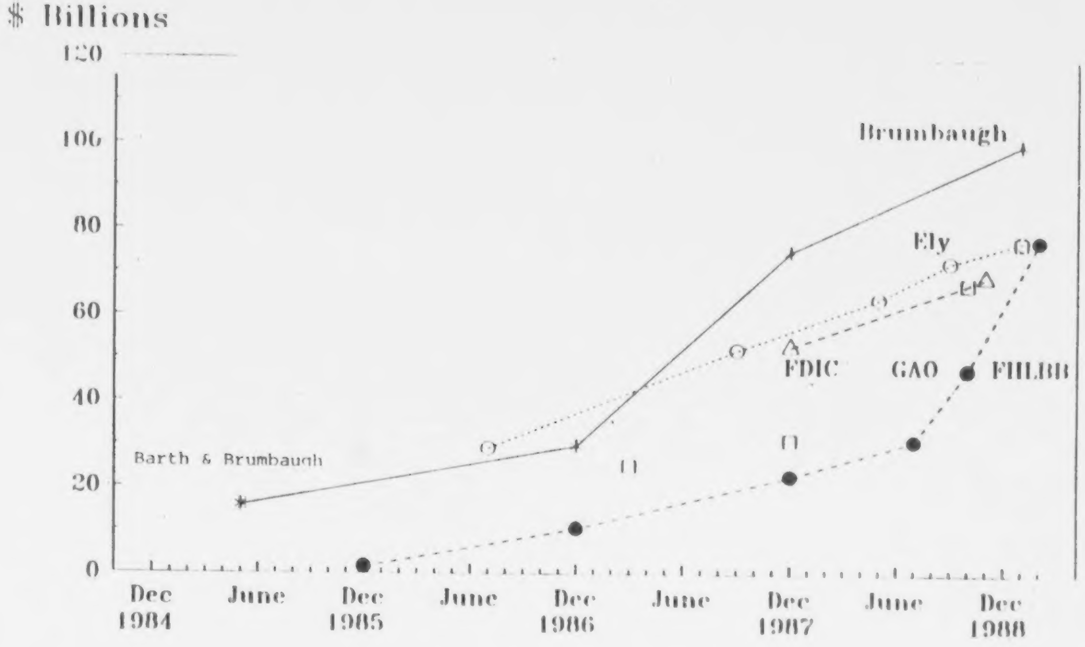
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Number of Institutions	3,993	3,751	3,287	3,146	3,136	3,246	3,220	3,147	2,949	2,878
Total Assets ($ Billions)	604	640	686	814	978	1,070	1,164	1,251	1,352	1,252
GAAP Net Worth ($Billions)	32	27	20	25	27	34	39	34	46	25
Tangible Net Worth ($ Billions)	32	25	4	4	3	9	15	9	23	10
Net Income ($ Millions)	781	(4,631)	(4,142)	1,945	1,022	3,728	131	(7,779)	(12,057)	(19,172)
Net Operating Income ($ Millions)	790	(7,114)	(8,761)	(46)	990	3,601	4,562	2,850	907	(2,913)
Net Nonoperating Income ($ Millions)	398	964	3,041	2,567	796	2,215	(1,290)	(7,930)	(11,012)	(15,449)
Taxes ($ Millions)	407	(1,519)	(1,578)	576	764	2,087	3,141	2,699	1,952	800
Percent of Home Mortgages to Total Assets	66.5	65.0	56.3	49.8	44.9	42.4	38.9	37.8	38.6	40.7
Percent of Mortgage Backed Securities to Total Assets	4.4	5.0	8.6	10.9	11.1	10.4	13.1	15.6	15.4	13.7
Percent of Mortgage Assets to Total Assets	70.9	70.0	64.9	60.7	56.0	52.8	52.0	53.4	54.0	54.4
Stock Institutions										
(% of Number of Institutions)	20.0	21.0	23.0	24.0	30.0	33.0	37.0	40.0	44.0	43.0
(% of Total Assets)	27.0	29.0	30.0	40.0	52.0	56.0	62.0	70.0	74.0	71.0
Federally-Chartered										
(% of Number of Institutions)	50.0	51.0	51.0	51.0	54.0	53.0	54.0	56.0	58.0	62.0
(% of Total Assets)	56.0	63.0	70.0	66.0	64.0	64.0	64.0	65.0	71.0	76.0
TAP Capital-to-Asset Ratio										
< 0%										
Number	43	112	415	515	695	705	672	672	508	517
Total TAP-Assets ($ Billions)	0.4	29	220	234	336	335	324	336	283	283
0% to 1.5%										
Number	63	178	291	310	327	266	227	194	160	122
Total TAP-Assets ($ Billions)	4	50	81	88	153	135	144	143	182	60
1.5% to 3.0%										
Number	230	524	592	569	526	460	354	277	281	245
Total TAP-Assets ($ Billions)	39	113	136	185	168	212	191	196	244	206
3% to 6%										
Number	1,956	1,766	1,202	1,091	945	1,009	995	891	864	814
Total TAP-Assets ($ Billions)	379	348	190	222	227	259	316	356	418	480
> 6%										
Number	1,701	1,171	787	661	643	806	972	1,113	1,136	1,180
Total TAP-Assets ($ Billions)	181	101	59	84	62	95	156	188	196	206
Resolutions										
Number	11	28	63	36	22	30	46	47	205	37
Total Assets ($ Millions)	1,458	13,908	17,662	4,631	5,080	5,601	12,455	10,660	100,660	9,662
Estimated Present-Value Cost ($ Millions)	167	759	803	275	743	979	3,065	13,704	31,180	5,608

Note: Data for 1989 is for all thrifts. At year-end, there were 281 institutions in conservatorship with assets of $92.6 billion. Resolutions in 1988 do not include 18 "stabilizations" that had assets of $7,463 million and tangible net worth of negative $3,348 million, and an estimated present value resolution cost of $6,838 million. Resolutions in 1989 do not include 7 FSLIC resolutions (reportedly at no cost to FSLIC) and 2 RTC resolutions (reportedly at no cost to RTC).

Source: Federal Home Loan Bank Board and Office of Thrift Supervision.

Chart 1

Selected Estimates of Thrift Insolvency Costs



Source: Federal Home Loan Bank Board.

Notes to Chart 1

All estimates are on a present-value basis, except as noted, meaning that this is the amount the FSLIC would have to pay to an acquirer to immediately assume its liabilities. When the estimate was stated as a range, the midpoint of the range was charted. The estimates prior to 1988 do not include costs associated with FSLIC's provisions for future losses on assistance agreements or FSLIC's notes payable.

Dan Brumbaugh is a consultant based in San Francisco, California. Brumbaugh arrives at his estimates by multiplying the assets of a predefined group of institutions by the FSLIC's average historical cost to resolve institutions during a recent period. Brumbaugh's December 1987 and January 1989 estimates include the costs of resolving solvent but troubled institutions. Brumbaugh's May 1985 and December 1986 estimates include only the costs of resolving insolvent institutions.

Bert Ely is a consultant based in Alexandria, Virginia. Ely's May 1988, September 1988, and January 1989 estimates are the simple average of the marked-down value of assets and the capitalized value of gross interest income. Estimates prior to May 1988 are based on the capitalized gross interest income stream. Ely's September 1987 estimate was stated as "at least 52 billion" and was based on March 1987 balance sheet data. Ely's September 1988 estimate was a range, $70-$75 billion, twenty to twenty-five percent of which was on the books of the FSLIC. Ely's January 1989 estimate was a range, $75-$80 billion, half of which was on the FSLIC's books. Ely's last two estimates were based on June 1988 financial data.

The General Accounting Office's January 1989 estimate was "at least $77 billion" of which $37 billion was for institutions that had already been resolved and $40 billion was for institutions that had not yet been resolved. The GAO's May 1988 estimate was a range, $26-$36 billion, and was based on the December 1987 financial audit. The GAO's estimates based on 1988 data were intended to include the costs of 1988 FSLIC actions to date that had been assumed by the FSLIC. The GAO's October 1988 estimate for the costs of resolving institutions that were insolvent at the end of September was a range, $45-$50 billion, to which $19.9 billion of FSLIC's provisions for losses and notes payable needs to be added. Thus, the October estimate ranged from $64.9-$69.9 billion. The GAO's March 1987 estimate is taken from its report to the Congress in which the GAO stated that given its "knowledge of the condition of the industry, we do not believe that $25 billion overstates the extent of the problem facing FSLIC."

The Federal Deposit Insurance Corporation's estimates include the costs of handling resolved institutions plus institutions that were unprofitable and insolvent. Institutions are insolvent for these estimates if the sum of tangible capital, loan loss reserves, and general valuation allowances is less than zero. The FDIC reduces the asset values at insolvent and unprofitable institutions by comparing the book value of these assets with corresponding book values of a related group of peer institutions. The liabilities of the insolvent and unprofitable institutions are then subtracted from the adjusted asset values to obtain a cost estimate for resolving these institutions. The FDIC's December 1987 estimate of $52.8 billion was based on 489 insolvent and unprofitable institutions holding assets of $209 billion. The FDIC's November 1988 estimate of $68.9 billion was based on 134 resolved institutions through October 20, 1988 and 396 institutions holding $167 billion in assets, yet to be resolved. The FDIC's November estimate was split between FLSICs' books, $24.8 billion, and the unresolved institutions.

The Bank Board's December 1985 estimate of $1.6 billion was a contingent liability for troubled institutions that the Bank Board believed would likely require financial assistance in the near term. This estimate was based on FSLIC's historical loss experience and an evaluation of the past and present financial condition of such institutions. This methodology focused on near term losses, and was not a projection of the cost of resolving all future problems in the savings and loan industry. The Bank Board's December 1986 estimate of $10.5 billion included only those institutions on the FSLIC case list as of December 31, 1986. This liability represented the present value of the estimated total cost to provide the most probable form of assistance in each case less any costs already recognized because of some currently provided FSLIC assistance. The Bank Board's December 1987 estimate of $22.7 billion or more included a contingent liability of $17.4 billion for future assistance to troubled (unresolved) institutions that was probable and estimable and the costs (at least $5.3 billion) to resolve the problems of the additional 300 GAAP-insolvent institutions. The contingent liability included bid prices received by the FSLIC and the estimable and probable resolution costs of the remaining thrifts in the FSLIC caseload; plus an additional allowance for institutions located in the Southwest that were not part of the FSLIC caseload as of December 31, 1987. The Bank Board's mid-year estimate of $30.9 billion revised the December 31, 1987 estimate upwards by $8.2 billion for institutions in the Southwest based on an analysis of actual resolution costs on Southwest cases compared to year-end estimates. The Bank Board's October 1988 estimate was a range, $45-$50 billion, based on all unresolved institutions in FSLIC's caseload a of October 1, 1988 plus all other thrifts that were GAAP insolvent in June 1988 but not in FSLIC's caseload. Using its experience from resolving thrifts during the first three quarter of the year, the Bank Board estimated a range of costs for the resolution of future FSLIC cases, $24.9 to $29.9 billion. To this must be added the estimated $20 billion in FSLIC notes and guarantees under assistance agreements of previously resolved cases. The Bank Board's February 1989 estimate is a range, $75-80 billion.

Table 3
Estimated Cost of Resolving the Thrift Crisis

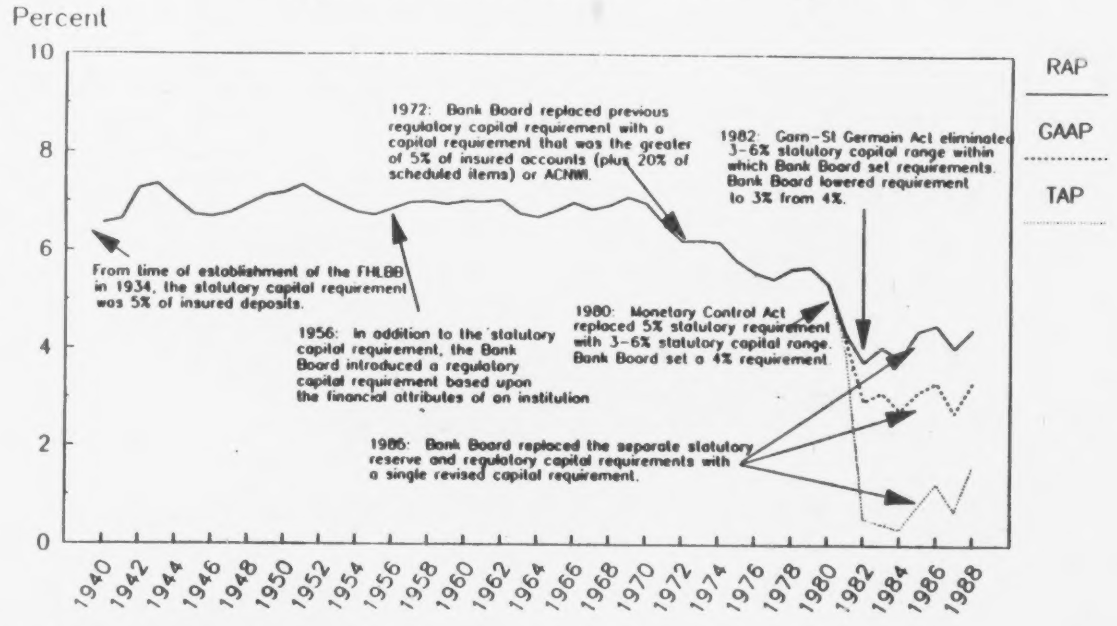
Source of Estimate	Estimated Cost ($ Billions)	Description
Ely (April 1990)	$125	Present-value estimate that includes $50 billion for pre-1989 resolutions.
Barth-Brumbaugh (April 1990)	$91-135	Present-value estimate that excludes pre-1989 resolutions. The estimate depends on the resolution costs per dollar of assets of resolved institutions.
Congressional Budget Office (March 1990)	$75-80	Cash-flow estimate based on the timing of working capital and expected return on assets. Limited to RTC-caseload.
Office of Management and Budget: OMB-1 (February 1989)	$158	The on-budget resolution costs as measured by gross outlays from 1989 to 1999, including pre-1989 resolutions.
OMB-2 (February 1989)	$198	Gross on-budget outlays and off-budget costs from 1989 to 199 for resolving failed thrifts and establishing SAIF, including those for pre-1989 resolutions.
General Accounting Office: GAO-1 (July 1989)	$257	Gross on-budget outlays and off-budget costs of restoring failed thrifts and establishing SAIF over a 33-year period, including those for pre-1989 resolutions.
GAO-2 (April 1990)	At least $325	Gross on-budget outlays and off-budget costs of restoring failed thrifts and establishing SAIF over a 40-year period, including those for pre-1989 resolutions.
GAO-3 (April 1990)	At least $140	Present-value estimate of GAO-2 stated by Mr. Bowser during questioing following testimony.

Source: Office of Thrift Supervision and Congressional Budget Office.

Chart 2

FSLIC INSURED INSTITUTIONS

Capital to Asset Ratios: 1940–1988



NOTE: RAP = Regulatory Accounting Practices
GAAP = Generally Accepted Accounting Principles
IAP = Tangible Capital

Source: Office of Thrift Supervision.

Table 4
Alternative Capital-to-Asset Ratios for the Thrift Industry: 1980-88

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Regulatory Capital (RAP)	5.3	4.4	3.8	4.1	3.8	4.4	4.6	4.1	4.4
Generally Accepted Accounting Principles Capital (GAAP)	5.3	4.2	2.9	3.1	2.8	3.2	3.4	2.7	3.4
Tangible Capital (TAP)	5.3	3.9	0.6	0.5	0.3	0.8	1.3	0.7	1.7
Market Value Capital (MVP)	(12.7)	(17.9)	(14.4)	(8.3)	(2.7)	1.5	2.3	0.3	1.7

Note: Last quarter of 1988 involved substantial FSLIC assistance.

Source: Federal Home Loan Bank Board.

Table 5
Comparison of Thrift Resolutions -- U.S. and Texas: 1980-1989

	Number of Resolutions		Total Assets of Resolutions ($ Billions)		Estimated Present Value Resolution Cost ($ Billions)		Average Number of Months of TAP-Insolvency	
Year	U.S.	Texas	U.S.	Texas	U.S.	Texas	U.S.	Texas
1980	11	0	1,458	--	167	--	5	--
1981	28	1	13,908	6	759	1	5	31
1982	63	8	17,662	1,031	806	78	8	11
1983	36	1	4,631	97	275	0	16	30
1984	22	2	5,080	348	743	164	23	16
1985	31	1	6,366	174	1,026	155	26	5
1986	46	2	12,455	1,080	3,065	493	31	14
1987	47	4	10,660	1,507	3,704	1,504	35	30
1988	205	81	101,242	35,978	31,790	19,491	42	38
1989	37	8	9,774	3,047	5,608	2,953	40	41

Note: Figures for 1989 may differ from previous years because of different methods of calculation by FSLIC and RTC. Resolution data for 1988 do not include 18 "stabilizations" that at year-end 1988 had assets of $7,463 million and tangible net worth of negative $3,348 million, and an estimated present value resolution cost of $6,838 million. Resolution data for 1989 do not include two RTC-cases reportedly resolved without cost to the RTC.

Table 6

Average Number of Months of TAP-Insolvency of Thrift Resolutions By State: 1980-89

District	State	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Boston	Massachusetts	0	0	7	0	0	0	0	0	0	0
	Rhode Island	19	0	0	0	33	0	0	0	0	0
New York	New Jersey	5	6	8	0	40	0	0	28	53	0
	New York	0	3	7	20	38	0	52	0	0	0
	Puerto Rico	0	5	7	0	40	0	0	0	0	0
Pittsburgh	Pennsylvania	0	0	8	14	0	0	0	0	0	49
	West Virginia	0	0	0	0	0	0	52	0	68	0
Atlanta	Alabama	0	0	0	24	0	0	0	41	78	63
	District of Columbia	0	24	0	0	0	38	0	0	0	0
	Florida	2	3	2	0	0	48	7	0	42	29
	Georgia	0	0	7	0	0	0	0	0	18	3
	Maryland	0	7	9	0	26	0	0	63	0	0
	North Carolina	0	1	0	0	0	0	0	60	14	15
	South Carolina	0	0	0	0	0	0	22	0	0	3
	Virginia	0	0	2	6	49	40	23	39	28	0
Cincinnati	Kentucky	0	0	10	0	0	29	54	0	44	0
	Ohio	3	0	0	11	24	40	41	38	58	0
	Tennessee	0	0	0	0	13	27	0	0	61	0
Indianapolis	Indiana	0	0	0	18	0	0	0	0	61	0
	Michigan	4	0	0	14	0	0	40	27	60	0
Chicago	Illinois	6	4	3	20	14	32	19	68	60	35
	Wisconsin	0	0	0	11	0	0	0	0	0	0
Des Moines	Iowa	4	0	0	18	0	24	0	17	42	20
	Minnesota	0	1	0	27	0	0	0	0	54	0
	Missouri	0	3	7	19	0	0	45	44	0	0
	North Dakota	0	3	6	0	27	0	0	0	0	0
	South Dakota	0	0	0	14	20	0	0	0	39	0
Dallas	Arkansas	0	0	0	0	0	3	72	15	39	49
	Louisiana	0	NA	20	16	16	22	33	36	17	65
	Mississippi	0	0	6	0	24	19	0	0	0	0
	New Mexico	5	0	8	23	0	52	51	0	16	0
	Texas	0	31	11	30	16	5	14	30	38	41
Topeka	Colorado	0	0	0	0	0	22	26	6	21	0
	Kansas	0	0	5	0	0	6	62	23	24	52
	Nebraska	0	0	0	0	0	0	0	7	0	87
	Oklahoma	0	0	0	0	0	0	25	67	27	0
San Francisco	California	0	0	18	0	18	12	19	37	36	30
	Nevada	0	0	0	0	0	0	4	0	0	0
Seattle	Alaska	0	5	0	0	0	0	5	6	0	0
	Hawaii	2	0	0	0	0	7	0	0	0	0
	Idaho	0	0	0	0	0	0	0	57	26	0
	Montana	0	0	2	0	0	26	0	0	66	0
	Oregon	0	0	0	0	0	42	25	30	57	0
	Utah	0	0	0	0	0	7	0	12	0	0
	Washington	0	0	0	0	0	21	24	30	34	0
	Wyoming	0	0	0	0	0	0	18	0	29	0

Table 7

Presence of Negligence & Fraud in 1988 Thrift Resolutions

All 205 Resolutions	Board Negligence	Bad Underwriting	Faulty Appraisals	Loans-To-One Borrower Violations	Professional Negligence	Self Dealing	Other Fraud
Yes	132	125	95	69	68	69	55
No	21	22	37	60	53	57	52
Too Early	50	56	71	74	82	77	96
No Claim	2	2	2	2	2	2	2

50 Costliest Resolutions	Board Negligence	Bad Underwriting	Faulty Appraisals	Loans-To-One Borrower Violations	Professional Negligence	Self Dealing	Other Fraud
Yes	35	36	29	25	26	25	21
No	1	1	2	6	5	8	6
Too Early	14	13	19	19	19	17	23
No Claim	0	0	0	0	0	0	0

Texas Resolutions (81 in 1988)	Board Negligence	Bad Underwriting	Faulty Appraisals	Loans-To-One Borrower Violations	Professional Negligence	Self Dealing	Other Fraud
Yes	48	45	35	31	21	31	19
No	3	4	6	11	33	8	8
Too Early	30	32	40	39	49	42	54
No Claim	0	0	0	0	0	0	0

All data collected and compiled during the period 2/9-22/89.

Note: this information based upon preliminary evaluations. If category was present, "Yes" was indicated. If category was not present, "No" was indicated. If it was too early to determine the presence of a category, then "Too Early" was indicated. In two cases, the FHLBB does not hold the D&O claim.

Source: Federal Home Loan Bank Board.

Table 8

Facts About Four Selected 1988 Thrift Resolutions

	Lamar Savings Association	American Diversified Savings Bank	Bell Savings & Loan Association	Eureka Federal Savings & Loan Association
State Located	Texas	California	California	California
Charter at Time of GAAP-Insolvency	State	State	State	Federal
Ownership Form	Stock	Stock	Stock	Mutual
Ownership Control	Closely Held	Closely Held	Widely Held	Not Applicable
Years of Ownership change (If Any)	1980	1983	1982	Not Applicable
Assets at Time of Resolution ($ Millions)	1,940	510	953	1,744
Estimated Resolution Cost ($ Millions)	805	798	566	303
Estimated Liquidation Cost ($ Millions)	953	798	700	396
Month of Resolution	May 1988	June 1988	September 1988	May 1988
Resolution Action	Southwest Plan	Insurance Action	Assisted Merger	Assisted Merger
Years of TAAP-Insolvency	6.25	2.5	2.5	3.75
Direct Investment to Assets (Industry Average = 0.5%)	15.8%	69.7%	2.6%	0.4%
Brokered Deposits to Assets (Industry Average = 1.8%)	3.2%	35.4%	5.2%	0.7%
Aquisition & Development Loans to Assets (Industry Average = 2.0%)	3.0%	0.1%	2.4%	0.4%
Real Estate Held to Assets (Industry Average = 1.8%)	9.2%	24.9%	1.7%	0.0%
Average Annual Growth Rate of Assets: 1983-1985	63.1%	346.3%	48.0%	17.1%
Year placed in MCP	Not Applicable	1986	1985	Not Applicable

Source: Federal Home Loan Bank Board

Table 9
Selected Information on 1988 Thrift Resolutions

Name of Institution	State	Estimated Present Value Resolution Cost ($ Millions)	Months of Tangible Insolvency	Charter at Time of GAAP-insolvency (F=Fed, S=State)	Ownership at Time of GAAP-Insolvency (M=Mutual, S=Stock)	Narrowness of Ownership	Average Annual Growth Rate 1983-1985 (%)	Percentage of Liabilities in Residential Mortgages	Percentage of Liabilities in Brokered Deposits
FIRST TEXAS SA	TX	2,601	27	S	S	Wide	16	24	5
AMERICAN SAVINGS	CA	1,699	66	S	S	Close	69	23	1
GIBRALTAR SA	TX	1,500	48	S	S	Close	11	21	4
GUARANTY FSLA	TX	1,386	45	F	S	Close	NA	14	13
UNITED SA OF TEXAS	TX	1,374	15	S	S	Wide	37	22	21
BEVERLY HILLS SAVINGS, FSLA	CA	983	63	S	M	...	44	16	27
BEACH FSLA	FL	978	45	S	M	...	NA	12	0
COMMODORE SA	TX	891	33	S	S	Close	90	10	27
LAMAR SA	TX	805	74	S	S	Close	63	17	3
AMERICAN DIVERSIFIED SB	CA	798	30	S	S	Close	130	3	15
PATHWAY FINANCIAL, FA	IL	791	87	F	S	Close	136	33	0
STATE OF LUBBOCK SA	TX	757	38	S	S	Wide	48	5	18
STOCKTON SA	TX	712	32	S	M	...	6	24	2
CHAMPION	TX	602	24	S	M	...	NA	24	12
BELL SLA, FSLA	CA	566	30	S	S	Close	49	37	4
FRANKLIN SA	TX	556	24	S	S	Close	35	16	25
CITY SLA	TX	524	83	S	S	Close	28	13	6
CREDITBANC SA	TX	504	66	S	S	Close	16	10	15
KILLEEN SLA	TX	460	24	S	S	Wide	51	9	27
CHARTER SLA	TX	458	78	S	M	...	8	19	7
SOUTHWEST S LA	TX	421	28	S	M	...	NA	19	13
CARDINAL FSB	OH	405	15	F	S	Close	87	38	2
HOME SA	TX	390	39	S	M	...	NA	42	7
LYONS SAVINGS, FSLA	IL	385	30	F	NA	NA	46	26	0
HEIGHT SA	TX	368	57	S	S	Close	30	30	6
MERCURY SA OF TEXAS	TX	333	32	S	M	...	17	10	13
EUREKA FSLA	CA	303	44	S	M	...	100	45	1
BUTTERFIELD SLA, FSLA	CA	281	45	S	S	Wide	63	29	3
BANC HOME SA	TX	272	67	S	S	Close	127	6	10
PEOPLES SLA	TX	235	33	S	S	Close	27	9	7
BEN MILAM SLA	TX	229	32	S	S	Close	82	2	23
MILE HIGH/SILVERADO	CO	228	9	S	S	Wide	24	13	17
RICHARDSON SLA	TX	224	77	S	S	Close	67	37	12
COLUMBIA FSLA	CO	221	15	F	S	Wide	24	21	5
PARIS SLA	TX	210	23	S	S	Close	92	14	26
HOME SLA	TX	203	69	S	M	...	0	12	10
FARMERS SAVINGS, A FSLA	CA	199	34	S	NA	NA	21	24	16
DELTA SA OF TEXAS	TX	196	72	S	M	...	10	13	6
AMERICAN SB	IL	188	90	S	S	Close	88	46	0
FIRST FSLA	TX	179	12	F	M	...	11	27	8
TWIN CITY SAVINGS, A FSA	LA	177	17	F	M	...	48	15	32
TESORO SLA	TX	161	23	S	S	Close	47	12	32
BROWARD FSLA	FL	151	30	F	S	Wide	39	23	4
LINCOLN FSLA	NJ	146	74	F	M	...	9	47	0
PETROPLEX SA	TX	143	49	S	M	...	NA	19	13
SAN ANGELO SA	TX	143	31	S	S	Close	-5	19	2
CITIZENS SLA, A FSLA	OR	141	64	S	M	...	16	24	2
MAJESTIC SA	TX	137	35	S	M	...	5	16	31
NORTH AMERICA SLA, A FSLA	CA	133	21	S	M	...	3	32	0
OLNEY SA	TX	133	7	S	M	...	-1	35	8
SOUTHERN FED BANC SLA	TX	132	42	S	M	...	5	9	10

Table 9 (Continued)
Selected Information on 1988 Thrift Resolutions

Name of Institution	State	Estimated Present Value Resolution Cost ($ Millions)	Months of Tangible Insolvency	Charter at Time of GAAP-insolvency (F=Fed, S=State)	Ownership at Time of GAAP-Insolvency (M=Mutual, S=Stock)	Narrowness of Ownership	Average Annual Growth Rate 1983-1985 (%)	Percentage of Liabilities in Residential Mortgages	Percentage of Liabilities in Brokered Deposits
KEY SLA, FSLA	CO	131	32	S	M	---	7	17	1
INTERWEST SA	TX	120	75	S	S	Close	64	11	14
COLUMBUS SLA	CA	115	33	S	S	Wide	78	55	0
CAL AMERICA SLA, FSLA	CA	113	30	S	NA	NA	60	22	5
AMERICAN HOME SAVINGS, FSB	OR	113	66	F	M	---	46	83	0
THE AMERICAN FSLA	OK	112	49	F	M	---	20	20	4
WASHINGTON FSB	NM	108	71	F	NA	NA	17	18	0
SENTRY SA	TX	99	27	F	M	---	7	13	31
SEGUIN SA	TX	99	54	F	S	Wide	1	17	12
SOUTHERN S LA	TX	99	52	S	NA	NA	35	34	14
HI-PLAINS SLA, FSLA	TX	97	75	S	S	Wide	7	18	43
NORTHPARK SA	TX	96	24	S	S	Wide	68	31	13
CYPRESS SA	FL	94	11	S	M	---	8	45	0
PIONEER FSLA	IA	94	80	F	M	---	17	48	0
UNITED SB OF WYOMING, FSB	WY	90	30	F	S	Wide	26	14	0
FIRST SA OF EAST TEXAS	TX	88	34	S	S	Wide	52	14	9
IRVING SA	TX	86	56	S	S	Close	18	12	16
ALLIANCE SLA	TX	84	35	S	M	---	78	33	0
FIRST FS LA	TX	84	70	S	M	---	10	34	0
SECURITY	TX	83	73	F	NA	NA	9	15	0
MONTFORT SA, FSA	TX	81	30	S	M	---	54	0	6
LIBERTY FSB	NM	80	16	F	M	---	NA	29	25
OHIO VALLEY SLA	OH	77	60	S	M	---	1	44	0
RAMONA FSLA	CA	76	47	S	S	Wide	81	-4	24
BRIERCROFT SA	TX	75	11	S	NA	NA	18	25	3
VISTA SA	TX	74	72	F	M	---	-12	17	15
FIRST FEDERATED SB	FL	73	21	F	S	Wide	93	28	11
FIRST FSLA OF HAMMONTON	NJ	72	56	F	NA	NA	10	45	0
AMERICAN FSLA	IN	67	46	F	M	---	1	35	0
MC LEAN FSA	VA	66	15	S	M	---	39	60	26
FIRST FINANCIAL SA	TX	66	66	S	S	Wide	52	23	4
FIRST FSB	IA	66	48	F	NA	NA	-4	27	2
MIDAMERICA	OK	65	18	F	M	---	-3	54	0
BAY CITY FSLA	TX	64	12	F	E	Wide	19	35	1
MUTUAL FSB	OK	64	63	S	M	---	22	28	0
JACKSON COUNTY FSLA	OR	63	45	F	M	---	39	53	0
BLOOMFIELD SLA, FA	MI	62	63	S	S	Close	122	42	0
RANCHERS SA	TX	62	30	S	NA	NA	105	4	61
LONGVIEW SLA	TX	62	74	S	S	Close	57	35	0
MAGNET BANK, FSB	WV	60	68	F	M	---	12	61	2
FIRST FINANCIAL SB	IA	60	72	S	S	Wide	79	44	0
SHAMROCK FS LA	TX	58	16	F	S	Wide	519	21	0
ROCKY MOUNTAIN FSLA	WY	57	27	F	M	---	6	37	0
FIRST DEARBORN, FA	MI	56	81	S	S	Wide	4	34	0
FIRST FSLA	OK	56	22	F	M	---	20	36	3
ULTIMATE SB, FSB	VA	56	15	F	M	---	30	28	4
COMMUNITY FIRST FED SAVINGS	WA	54	81	F	M	---	15	55	0
REGENCY SB, FSB	MI	52	40	S	M	---	5	66	31
FIRST FSLA	KY	52	18	F	M	---	5	42	0
ODESSA SA	TX	50	22	S	S	Wide	9	27	0
NORTHWEST FSLA OF SPENCER	IA	50	24	F	M	---	7	46	0

Table 9 (Continued)
Selected Information on 1988 Thrift Resolutions

Name of Institution	State	Estimated Present Value Resolution Cost ($ Millions)	Months of Tangible Insolvency	Charter at Time of GAAP-insolvency (F=Fed, S=State)	Ownership at Time of GAAP-Insolvency (M=Mutual, S=Stock)	Narrowness of Ownership	Average Annual Growth Rate 1983-1985 (%)	Percentage of Liabilities in Residential Mortgages	Percentage of Liabilities in Brokered Deposits
GREATWEST SAV BANC	TX	49	21	S	S	Close	24	15	32
ALLENPARK FSLA	TX	47	36	S	S	Close	24	16	11
MT WHITNEY SLA	CA	46	41	S	M	---	82	30	18
TERRITORY SLA	OK	46	29	S	M	---	112	20	16
UNITED SAVINGS, A FSLA	OK	44	18	F	M	---	30	33	0
SECURITY SLA	TX	42	11	S	S	Wide	1	33	3
FIRST WESTERN SLA	TX	42	9	S	S	Wide	20	14	35
INVESTORS SLA, A FSLA	OK	41	18	F	S	Close	NA	31	0
LEE SA	TX	40	21	S	S	Wide	NA	19	18
HOMESTATE SLA	CA	40	35	S	S	Wide	66	56	0
FIRST FSLA	TX	39	33	F	M	---	8	16	14
FIRST FSLA OF BRAINERD	MN	37	56	F	M	---	3	36	2
UNIVERSAL SA, A FSLA	OK	36	37	F	S	Wide	132	18	14
PEOPLES FSB	OH	35	79	F	NA	NA	12	44	0
CARDINAL SB, INC.	NC	34	14	S	S	Close	53	20	0
TAHOE SLA, FSLA	CA	34	45	S	M	---	73	42	0
RELIANCE SA	TX	33	54	S	S	Close	100	14	41
INDEPENDENCE SLA	TX	32	15	S	M	---	9	35	8
ARSENAL, SA, FA	IN	32	75	F	M	---	8	50	0
FIRST FSLA	TX	32	27	S	M	---	23	35	3
HEART O TEXAS SA	TX	31	22	F	S	Close	169	31	10
FIRST FSLA OF GRAND RAPIDS	MN	30	35	F	S	Wide	-1	47	5
FREEDOM FSLA	OR	29	72	S	M	---	25	33	7
FIRST FSLA	KY	25	61	F	M	---	3	28	0
BAYVIEW FSA	TX	25	12	F	S	Wide	28	24	4
FIRST FSB	AR	24	42	F	M	---	19	46	0
FLAGSHIP FSLA	CA	24	38	S	S	Wide	46	36	1
FIRST OKLAHOMA	OK	24	18	F	M	---	72	577	1
FIRST FSB OF INDIANA	IN	23	60	F	M	---	-1	73	0
MUTUAL SLA	IL	23	55	S	S	Wide	113	45	0
FIRST FSLA OF HIBBING	MN	22	56	F	S	Wide	19	21	0
PEOPLES FSLA	IA	22	12	F	S	Wide	41	63	0
GULF COAST SA	TX	21	33	F	S	Close	40	44	0
KEYSTONE SLA	TX	20	48	S	M	---	NA	41	4
GLEN ELLYN SLA, FSLA	IL	20	39	S	M	---	12	47	0
COLORADO COUNTY FSLA	TX	20	29	F	M	---	-2	42	0
UNION SA	TX	20	24	S	NA	NA	61	12	1
FIRST FSLA	FL	20	81	F	M	---	2	51	0
ROOKS COUNTY FSA	KS	20	24	S	S	Close	19	29	0
AMERICAN BANC SA	TX	19	47	S	S	Wide	NA	50	15
REPUBLIC SAVINGS FSLA	IL	18	58	S	S	Wide	27	40	0
BROWNFIELD SLA	TX	17	36	S	M	---	17	19	7
PEORIA SLA	IL	17	69	S	M	---	6	27	0
COMMERCE FSB	TN	17	29	F	S	Wide	182	31	0
THE PERPETUAL SLA	IA	17	45	S	S	Close	31	64	0
CAPITOL F S OF AMERICA	IL	17	77	F	M	---	12	67	0
TRI-CITIES SLA	WA	16	22	S	NA	NA	181	42	0
PEOPLES SLA	OR	16	39	S	S	Wide	10	22	3
FIRST SECURITY SB	CA	15	18	F	M	---	25	28	6
METROPLEX FSA	TX	15	6	F	S	Wide	NA	37	21
SKYLINE SA	TX	15	8	S	S	Wide	39	31	0
FIRST FSLA	WA	14	29	F	M	---	4	57	0

Table 9 (Continued)
Selected Information on 1988 Thrift Resolutions

Name of Institution	State	Estimated Present Value Resolution Cost ($ Millions)	Months of Tangible Insolvency	Charter at Time of GAAP-insolvency (F=Fed, S=State)	Ownership at Time of GAAP-Insolvency (M=Mutual,S=Stock)	Narrowness of Ownership	Average Annual Growth Rate 1983-1985 (%)	Percentage of Liabilities in Residential Mortgages	Percentage of Liabilities in Brokered Deposits
GLADEWATER FSLA	TX	14	71	F	M	---	3	20	1
CAPITAL FSB	OK	14	6	S	S	Wide	1	120	1
MIDAMERICA SB	IA	14	24	S	M	---	-1	60	0
FIRST BORDER SB	OH	14	60	S	M	---	9	131	21
VIRGINIA FSLA	VA	14	54	S	S	Close	41	36	0
YOAKUM FSLA	TX	13	24	S	M	---	1	44	0
FIRST FSLA OF FREEPORT	IL	13	43	F	M	---	5	31	0
COOSA FSLA	AL	13	78	F	S	Wide	14	36	0
RELIANCE SLA	NJ	12	29	F	M	---	-5	43	0
GREAT FALLS FSLA	MT	11	66	F	M	---	3	28	1
MOUNTAIN STATE FSLA	WV	11	80	F	M	---	2	71	0
WESTERN FSLA	IA	11	53	S	M	---	-4	31	1
SOUTHSIDE SLA	OH	10	77	S	M	---	6	52	0
TRADERS FSLA	WV	10	56	F	M	---	5	55	2
FRONTIER FSB	TN	10	81	S	M	---	8	35	0
BLUEBONNET SA OF TEXAS	TX	9	50	S	M	---	53	19	0
STANFORD SLA	CA	9	12	S	S	Wide	107	29	0
HOME FSLA OF PEORIA	IL	9	61	F	M	---	13	47	0
SOUTH FLORIDA SAVINGS, FSLA	FL	9	39	S	S	Close	NA	30	0
UNITED SA OF CENTRAL INDIANA	IN	8	63	S	S	Wide	52	66	0
PEOPLES SLA, FA	MN	8	53	F	S	Wide	4	38	0
UNITED FSLA	SD	8	39	F	M	---	-2	67	1
SOUTHLAND SA	TX	8	17	S	S	Close	NA	21	0
MESQUITE SLA	TX	8	54	S	M	---	4	37	0
VALLEY FSLA	TN	7	73	F	M	---	36	54	0
LARUE FSLA	KY	7	54	F	M	---	-3	23	0
CITIZENS SLA	IL	6	52	S	NA	NA	36	21	0
LYNNWOOD SLA	WA	6	24	S	M	---	47	6	0
CITIZENS FSLA OF NEW CASTL	IN	6	54	S	M	---	3	57	0
CAPITAL FSLA	IN	5	75	S	S	Wide	34	52	0
BURNET SLA	TX	5	27	S	S	Wide	57	44	10
HOME FSLA OF SPENCER	IA	5	33	S	S	Wide	3	32	0
LOVES PARK FSB	IL	5	48	F	S	Wide	30	54	0
FIRST FSLA	GA	5	18	S	M	---	31	55	0
MINERAL WELLS SLA	TX	5	39	S	M	---	14	48	0
COMMERCE FSLA	TX	4	47	F	M	---	-7	42	0
MUSKEGON FSLA	MI	4	54	F	M	---	8	75	0
FIRST FSLA	CO	4	27	S	M	---	13	59	0
FIDELITY FSLA OF BERWYN	IL	4	60	F	M	---	3	31	0
CENTRAL ARKANSAS SLA	AR	3	35	S	S	Wide	149	36	0
ADOBE SB	CA	3	18	S	S	Close	44	32	1
FRANKTON FSLA	IN	3	57	S	M	---	9	68	0
FIRST FSLA OF TAYLORVILLE	IL	3	71	F	S	Wide	38	42	0
NORTHWEST FSLA	ID	2	26	F	S	Wide	57	63	0
GALVA FSLA	IL	2	55	S	M	---	4	75	0
EASTERN WASHINGTON, SLA	WA	2	12	S	S	Close	346	30	15
FIRST FEDERAL BANK, FSB	IA	1	32	F	M	---	10	46	3
LAMESA FSLA	TX	1	9	S	M	---	18	64	2
CAMERON COUNTY SA	TX	0	14	F	S	Wide	102	41	0
VICTOR SLA, A FSLA	OK	0	22	F	S	Wide	22	27	3
CITIZENS FSLA	FL	(1)	66	F	S	Wide	13	30	0

Table 10

Staffing of Federal Depository Institution Regulatory Agencies
(Fiscal Year, Permanent Full-Time Positions)

Agency	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Comptroller of the Currency	1,920	2,546	3,331	3,071	3,071	2,917	3,250	3,250	3,250	3,418	3,680
Federal Deposit Insurance Corporation	2,669	3,614	3,691	3,554	3,435	3,554	3,554	3,554	4,258	3,266	3,483
Federal Reserve System: (Note 1)											
Federal Reserve Banks	761	1,019	1,589	1,733	1,796	1,862	1,885	1,912	2,087	2,147	2,223
Board of Governors	188	298	330	355	344	359	404	440	352	413	429
	949	1,317	1,919	2,088	2,140	2,221	2,289	2,352	2,439	2,560	2,652
Federal Home Loan Bank System:											
Federal Home Loan Banks	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Federal Home Loan Bank Board	523	1,182	1,617	1,574	1,815	2,087	2,570	4,135	6,039	6,297	6,387
National Credit Union Administration	456	410	488	451	441	407	384	407	483	524	586
Total	6,517	9,069	11,046	10,738	10,902	11,186	12,047	13,698	16,469	16,065	16,788

Costs of Federal Depository Institution Regulatory Agencies
(Fiscal Year, Millions of Dollars of "Obligations")

Agency	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Comptroller of the Currency	32	65	113	121	129	144	167	170	189	193	218
Federal Deposit Insurance Corporation	39	63	113	124	131	78	274	232	462	326	565
Federal Reserve System: (Note 1)											
Federal Reserve Banks	NA	NA	86	100	119	132	141	152	164	170	187
Board of Governors	5	11	20	21	22	25	26	28	29	24	25
	5	11	106	121	141	157	167	180	193	194	212
Federal Home Loan Bank System: (Note 2)											
Federal Home Loan Banks	10	39	55	77	91	116	144	198	317	385	420
Federal Home Loan Bank Board	3	6	9	11	12	13	15	13	10	9	11
	13	45	64	88	103	129	159	211	327	394	431
National Credit Union Administration	7	10	18	22	20	19	22	22	24	30	35
Total	96	194	414	476	524	527	789	815	1,195	1,137	1,461

Note 1: Data for Federal Reserve System are on a calender year basis.
Note 2: Data for Federal Home Loan Bank System based on operating expense from Annual Reports.

Sources: Center for the Study of American Business, Washington University and Federal Home Loan Bank Board.

Table 11

Depository Institution Regulatory Resources: Staffing

Ratio	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Number of National Banks/OCC Staff	2.41	1.86	1.33	1.45	1.49	1.63	1.52	1.53	1.50	1.35	1.26
Number of FDIC-Insured Banks/FDIC Staff	5.19	4.07	4.15	4.32	4.49	4.15	4.16	4.17	3.45	4.35	3.91
Number of Member Banks/FRS Staff	1.21	0.79	0.52	0.49	0.49	0.47	0.46	0.46	0.45	0.43	0.43
Number of FDIC-Insured Banks/Bank Regulator Staff	2.50	1.97	1.71	1.76	1.78	1.70	1.63	1.62	1.48	1.54	1.39
Number of FSLIC-Insured Thrifts/FHLBS Staff	8.35	3.45	2.47	2.38	1.81	1.51	1.22	0.79	0.53	0.50	0.46
Number of NCUSIF-Insured Credit Unions/NCUA Staff	28.46	38.48	35.55	37.61	37.76	39.04	39.57	36.97	30.42	27.36	23.68
Total Number of Depositories/Depository Institution Regulatory Staff	4.78	3.81	3.32	3.36	3.24	3.02	2.75	2.42	1.98	1.97	1.81
($000)											
Assets of National Banks/OCC Staff	178,447	219,070	NA	312,001	348,415	402,990	460,974	502,377	536,663	519,176	502,764
Assets of FDIC-Insured Banks/FDIC Staff	215,943	263,545	NA	516,942	591,841	618,487	756,626	826,140	746,351	999,007	980,503
Assets of Member Banks/FRS Staff	132,203	137,050	NA	137,970	154,250	151,705	199,702	210,721	219,073	206,770	201,455
Assets of FDIC-Insured Banks/Bank Regulator Staff	104,072	127,384	NA	210,859	235,135	252,888	295,727	320,675	319,490	352,959	347,946
Assets of FSLIC-Insured Thrifts/FHLBS Staff	326,281	279,407	373,531	406,607	377,961	390,034	380,545	258,767	192,747	184,850	182,245
Assets of NCUSIF-Insured Credit Unions/NCUA Staff	19,432	70,278	119,641	136,951	157,785	201,378	241,781	294,135	305,855	309,469	299,155
Assets of Depositories/Depository Institution Regulatory Staff	115,982	144,616	NA	236,448	255,784	276,602	312,102	301,198	272,615	285,647	283,202

Note: Staffing of regulators on fiscal year basis (except for Federal Reserve System), assets and numbers of institutions on calender year basis.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration, and Center for the Study of Business, Washington University.

Table 12

Depository Institution Regulatory Resources: Costs

Ratio	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
OCC Costs/Number of National Banks	6,925	13,702	25,537	27,160	28,178	30,309	33,895	34,109	38,769	41,712	47,176
FDIC Costs/Number of FDIC-Insured Banks	2,818	4,282	7,371	8,076	8,500	5,283	18,530	15,666	31,469	22,946	41,450
FRS Costs/Number of Member Banks	4,359	10,516	106,319	118,627	135,577	149,240	156,955	167,442	176,095	177,007	184,830
Total Bank Regulator Costs/Number of FDIC-Insured Banks	5,491	9,447	21,657	23,836	26,019	25,672	41,117	39,300	57,489	50,187	72,995
FHLBS Costs/Number of FSLIC-Insured Thrifts	2,978	11,035	16,028	23,460	31,336	41,004	50,702	65,003	101,553	125,199	146,151
NCUA Costs/Number of NCUSIF-Insured Credit Unions	539	634	1,037	1,297	1,201	1,196	1,448	1,462	1,633	2,093	2,522
Depository Institution Regulatory Cost/ Number of Depository Institutions	3,079	5,612	11,289	13,197	14,822	15,592	23,825	24,622	36,663	35,880	47,968
OCC Costs/Assets of National Banks	0.00009	0.00012	NA	0.00013	0.00012	0.00012	0.00011	0.00010	0.00011	0.00011	0.00012
FDIC Costs/Assets of FDIC-Insured Banks	0.00007	0.00007	NA	0.00007	0.00006	0.00004	0.00010	0.00008	0.00015	0.00010	0.00017
FRS Costs/Assets of Member Banks	0.00004	0.00006	NA	0.00042	0.00043	0.00047	0.00037	0.00036	0.00036	0.00037	0.00040
Bank Regulator Costs/Assets of FDIC-Insured Banks	0.00013	0.00015	NA	0.00020	0.00020	0.00017	0.00023	0.00020	0.00027	0.00022	0.00029
FHLBS Costs/Assets of FSLIC-Insured Thrifts	0.00008	0.00014	0.00011	0.00014	0.00015	0.00016	0.00016	0.00020	0.00028	0.00034	0.00037
NCUA Costs/Assets of NCUSIF-Insured Credit Unions	0.00079	0.00035	0.00031	0.00036	0.00029	0.00023	0.00024	0.00018	0.00016	0.00019	0.00020
Depository Institution Regulatory Cost/ Assets of Depository Institutions	0.00013	0.00015	NA	0.00019	0.00019	0.00017	0.00021	0.00020	0.00027	0.00025	0.00031

Note: Expenditures of regulators on fiscal year basis (except for Federal Reserve System), assets and numbers of institutions on calender year basis. For 1970 and 1975, Federal Reserve System costs understated because data on district bank expenditures unavailable.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration, and Center for the Study of Business, Washington University.

Table 13

Deposit Insurance Systems

Country	Insuring Agency	Year Established	Membership	Administration
Argentina	Deposit Insurance Scheme (Central Bank)	1979	Voluntary	Officially Sponsored & Administered
Austria	Deposit Guarantee Fund	1987	Compulsory	Industry Arrangement
Belgium	Rediscount & Guarantee Institute	1985	Voluntary	Joint Administration
Canada	Canada Deposit Insurance Corporation	1967	Compulsory	Officially Sponsored & Administered
Chile	Superintendent of Banks & Financial Institutions	1986	Voluntary	Officially Sponsored & Administered
Colombia	Financial Institutions Guarantee Fund	1985	Compulsory	Joint Administration
Finland	Guarantee Fund	1969	Compulsory	Industry Arrangement
France	Deposit Guarantee Fund	1980	Voluntary	Industry Arrangement
Germany (Fed. Rep.)	Deposit Security Fund	1966	Voluntary	Industry Arrangement
	Savings Bank Security Fund	1969	Compulsory	Industry Arrangement
	Credit Cooperatives Security Scheme	1976	Compulsory	Industry Arrangement
India	Deposit Insurance & Credit Guarantee Corp.	1961	Compulsory	Industry Arrangement
Ireland	NA	1989	Compulsory	Officially Sponsored & Administered
Italy	Interbank Deposit Protection Fund	1987	Voluntary	Industry Arrangement
Japan	Deposit Insurance Corporation	1971	Compulsory	Industry Arrangement
Kenya	Deposit Protection Fund Board	1985	Compulsory	Officially Sponsored & Administered
Netherlands	Collective Guarantee Scheme	1979	Compulsory	Joint Administration
Nigeria	Nigerian Deposit Insurance Corporation	1988	Compulsory	Officially Sponsored & Administered
Norway	Guarantee Fund	1961	Compulsory	Joint Administration
Pakistan	Bank Deposit Insurance Programme	1974	Compulsory	Officially Sponsored & Administered
Paraguay	Sistema Nacional de Ahorro Y Prestamo para la Vivienda	1971	Voluntary	Officially Sponsored & Administered
Philippines	Philippine Deposit Insurance Corporation	1963	Compulsory	Joint Administration
Spain	Deposit Guarantee Fund	1977	Voluntary	Officially Sponsored & Administered
Sweden	Deposit Insurance Fund	NA	NA	Industry Arrangement
Switzerland	Deposit Guarantee Scheme	1984	Voluntary	Officially Sponsored & Administered
Trinidad & Tobago	Deposit Insurance Corporation	1986	Compulsory	Industry Arrangement
Turkey	Turkish Deposit Insurance Fund	1983	Compulsory	Joint Administration
United Kingdom	Deposit Protection Fund	1982	Compulsory	Officially Sponsored & Administered
United States	Federal Deposit Insurance Corporation: Bank Ins. Fund	1933	Voluntary	Officially Sponsored & Administered
	FDIC: Savings Association Insurance Fund	1989	Voluntary	Officially Sponsored & Administered
	National Credit Union Share Insurance Fund	1970	Voluntary	Officially Sponsored & Administered
Venezuela	Bank Deposit Guarantee & Protection Fund	NA	NA	NA

Source: Organization for Economic Co-Operation and Development, Federal Deposit Insurance Corporation, International Monetary Fund, World Bank, and annual reports of the Philippine Deposit Insurance Corporation and the Deposit Insurance & Credit Guarantee Corporation of India.

Table 14

Insurance Coverage and Pricing Schemes of Deposit Insurance Systems

Country	Insurance Coverage Limit (Domestic Currency)	U.S. $ Equivalent (as of 4/25/90)	Premium Pricing Scheme
Argentina	100% of deposits up to A$ 100,000,000, 90% above that amount	---	0.03% of total deposits
Austria	A$ 200,000	16,936	Unfunded Arrangement
Belgium	BF 500,000	14,445	0.02% of specified liabilities
Canada	C$ 60,000	51,690	0.1% of insured deposits
Chile	100% of demand deposits, 90% other deposits up to 120 UF	---	Unfunded Arrangement
Colombia	75% of Col$ 200,000	319	0.5% of required reserves on deposits
Finland	FM 500,000	126,040	Between 0.01% and 0.05% of total assets
France	FF 400,000	71,024	Collected as needed, assessments based on deposits
Germany [DSF]	30% of the "liable capital of bank concerned per depositor"	---	0.03% of total deposits
[SBSF]	100% of deposits and credits	---	0.03% of "claims on customers"
[CCSS]	100% of deposits and credits	---	Complex premiums and mutual guarantees
India	Rs 30,000	1,737	0.04% of total deposits
Ireland	80% of first IRP 5,000, 70% of next IRP 5,000, 50% of next IRP 5,000	15,925	0.2% of deposits
Italy	100% of first L 200,000,000, 90% of next L 800,000,000, 80% of next L 2,000,000,000	2,048,256	Unfunded Arrangement
Japan	Y 10,000,000	60,300	0.008% of covered deposit balance
Kenya	Kshs 100,000	NA	0.1% of deposits
Netherlands	G 35,000	18,533	Unfunded Arrangement
Nigeria	N. 50,000	NA	0.937% of deposits
Norway	Unlimited	---	0.015% of total assets
Pakistan	NA	NA	NA
Paraguay	G 5,000,000	NA	.25% of deposits
Philippines	P 15,000	675	0.0667% of total deposits
Spain	Pts 1,500,000	14,165	.2% of deposits
Sweden	NA	---	Fund at such a level that in recent years annual contributions considered to be unnecessary
Switzerland	SF 30,000	20,541	Unfunded Arrangement
Trinidad & Tobago	TT$ 50,000	NA	NA
Turkey	TL 3,000,000	1,206	0.3% of insured deposits
United Kingdom	75% of deposit balance up to L 10,000	12,281	Progressive levy with the effective rate not to exceed 0.3% of domestic sterling deposits
United States [BIF]	US$ 100,000	100,000	0.12% of deposits in 1990, 0.15% thereafter
[SAIF]	US$ 100,000	100,000	0.208% of deposits in 1990, 0.23% in 1991-93, 0.18% in 1994-97, 0.15% thereafter
[NCUSIF]	US$ 100,000	100,000	May assess 0.083% of insured shares; since 1984, assessed only to maintain level of 1% of insured shares
Venezuela	NA	NA	NA

Source: Organization for Economic Co-Operation and Development, Federal Deposit Insurance Corporation, International Monetary Fund, Congressional Research Service, World Bank, and annual reports of the Philippine Deposit Insurance Corporation and the Deposit Insurance & Credit Guarantee Corporation of India.

Table 15

Selected Characteristics of Deposit Insurance Systems

Country		Coverage of Interbank Deposits	Coverage of Deposits Held By Nonresidents	Coverage of Deposits in Foreign Currency	Coverage of Deposits in Domestic Branches of Foreign Banks	Coverage of Deposits in Foreign Branches of Domestic Banks
Argentina		N	Y	N	---	---
Austria		N	Y	Y	N	N
Belgium		N	Y	N	N	N
Canada		Y	Y	N	---	N
Chile		N	Y	N	Y	N
Colombia		Y	Y	---	---	---
Finland		---	---	---	---	---
France		N	Y	N	Y	N
Germany	[DSF]	N	Y	Y	Y	Y
	[SBSF]	---	---	---	---	---
	[CCSS]	---	---	---	---	---
India		N	Y	N	N	N
Ireland		---	---	P	---	---
Italy		N	---	Y	---	Y
Japan		N	Y	N	N	Y
Kenya		Y	Y	---	---	---
Netherlands		N	Y	Y	Y	N
Nigeria		Y	Y	Y	Y	N
Norway		Y	Y	Y	Y	Y
Pakistan		Y	Y	Y	Y	Y
Paraguay		N	Y	N	N	---
Philippines		N	---	Y	--	---
Spain		N	Y	N	---	N
Sweden		---	---	---	---	---
Switzerland		N	Y	Y	N	---
Trinidad & Tobago		Y	Y	Y	Y	N
Turkey		N	Y	Y	N	N
United Kingdom		N	Y	N	Y	N
United States		Y	Y	Y	Y	N
Venezuela		---	---	---	---	---

Note: N = No, Y = Yes, P = Provisionally, --- = Information Unavailable

Source: Federal Deposit Insurance Corporation and World Bank.

Appendix

All Tangible Insolvent Thrift Institutions: Tangible Net Worth and Length of Insolvency
December 31, 1989

Source: Office of Thrift Supervision

Docket Number	Months Since First Insolvency	Months of Consistent Insolvency	Conservatorship Dummy Variable	Institution Name	City	St	Tangible Net Worth ($ mil)	GAAP Net Worth ($ mil)	GAAP Assets ($ mil)	Tangible Assets ($ mil)
3406	15	15	1	1ST FSALA OF ESTHERVILLE & EMMETSBURG	ESTHERVILLE	IA	-7.3	-7.3	47.8	47.8
2953	39	6	0	ABQ BANK, A FEDERAL SAVINGS BANK	ALBUQUERQUE	NM	-117.8	-93.7	2018.7	1994.6
8583	45	45	1	ALAMO FSA OF TEXAS	SAN ANTONIO	TX	-336.9	-336.9	528.9	528.9
3573	90	90	0	ALBANY FIRST FS & LA	ALBANY	GA	-3.1	0.5	183.6	179.9
8641	18	18	1	ALPINE SAVINGS, A FS & LA	STEAMBOAT SPRINGS	CO	-8.7	-8.7	45.5	45.5
1398	84	84	0	AMERICAN BANK, FSB	SANFORD	ME	-6.4	0.7	51.8	44.6
4099	0	0	0	AMERICAN CHARTER FS & LA	LINCOLN	NE	-2.0	-2.0	1386.7	1386.7
1872	90	90	0	AMERICAN FEDERAL BANK, FSB	GREENVILLE	SC	-12.7	36.0	1113.2	1064.5
6675	78	78	1	AMERICAN FS & LA	ALBUQUERQUE	NM	-33.4	-33.4	142.1	142.1
7299	21	21	0	AMERICAN FS & LA OF ADA	ADA	OK	-1.4	4.9	108.2	101.9
3965	72	72	0	AMERICAN FS & LA OF IOWA	DES MOINES	IA	-33.4	3.6	910.7	873.7
8675	3	3	1	AMERICAN HOME S & LA, FA	EDMOND	OK	-4.2	-4.2	83.9	83.9
8595	9	9	1	AMERICAN INTERSTATE SA, FA	LOS ANGELES	CA	-1.9	-1.9	19.4	19.4
7796	9	9	0	AMERICAN PIONEER SAVINGS BANK	ORLANDO	FL	-7.1	45.2	1754.5	1702.2
6917	78	39	1	AMERICAN S & LA OF BRAZORIA	LAKE JACKSON	TX	-163.0	-163.0	189.4	189.4
8618	21	21	1	AMERICAN S & LA, FA	NEW ORLEANS	LA	-15.0	-15.0	53.8	53.8
8670	12	12	1	AMERICAN SAVINGS OF COLORADO, A FSALA	COLORADO SPRINGS	CO	-217.2	-217.2	681.5	681.5
8665	96	96	1	AMERICAN SAVINGS, A FS & LA	SALT LAKE CITY	UT	-258.7	-258.7	1748.4	1748.4
104	63	18	1	AMERICAN SECURITY FS & LA	CHICAGO	IL	-5.9	-5.9	33.4	33.4
6743	69	66	1	AMERIBANC SAVINGS BANK, FSB	HILLSBORO	IL	-8.8	-8.8	17.3	17.3
6907	33	33	1	AMERIWAY SAVINGS	HOUSTON	TX	-147.1	-147.1	117.5	117.5
8632	84	33	1	ANCHOR FS & LA	KANSAS CITY	KS	-76.7	-76.7	657.8	657.8
7814	96	96	0	ANCHOR SAVINGS BANK, FSB	NORTHPORT	NY	-89.0	412.0	8928.2	8427.2
8710	90	90	1	ARLINGTON HEIGHTS SA, FA	ARLINGTON HEIGHTS	IL	-23.1	-23.1	509.8	509.8
8628	46	46	1	ARROWHEAD PACIFIC FSB	SAN BERNARDINO	CA	-33.8	-33.8	66.5	66.5
8694	18	18	1	ASPEN SAVINGS BANK, FSB	ASPEN	CO	-21.7	-21.7	111.9	111.9
3546	0	0	0	ATLANTA FS & LA	ATLANTA	TX	-1.2	-1.2	94.6	94.6
2555	90	90	0	ATLANTIC FINANCIAL FEDERAL	BALA CYNWYD	PA	-359.7	-359.7	5299.4	5299.4
8711	90	33	1	ATLANTIC PERMANENT FSB	NORFOLK	VA	-17.9	-17.9	559.9	559.9
3009	78	3	0	AURORA FSB	AURORA	IL	-2.9	-2.9	320.0	320.0
8706	3	3	1	AUSTIN FS & LA	AUSTIN	TX	-1.3	-1.3	106.4	106.4
840	15	15	1	BALDWIN COUNTY FEDERAL SAVINGS BANK	ROBERTSDALE	AL	-10.3	-10.3	155.8	155.8
1718	90	90	1	BALTIMORE FEDERAL FINANCIAL, FSA	BALTIMORE	MD	-265.4	-265.4	1183.8	1183.8
8680	[illegible]	[illegible]	1	BANC IOWA FEDERAL SAVINGS BANK	CEDAR RAPIDS	IA	-20.1	-20.1	146.5	146.5
6432	51	51	1	BANCPLUS SAVINGS ASSOCIATION	PASADENA	TX	-450.2	-450.2	489.2	489.2
7626	[illegible]	[illegible]	0	BANK USA SA	SILVIS	IL	-0.4	0.7	[illegible]	21.7
17	63	63	1	BANKERS S & LA	GALVESTON	TX	-18.0	-18.0	87.8	87.8
6228	0	0	0	BANNERBANC SAVINGS ASSOCIATION	GARLAND	TX	-10.2	-10.2	54.2	54.2
6124	30	30	1	BAYSHORE SA	LA PORTE	TX	-29.6	-29.6	38.1	38.1
2810	84	84	0	BEACON FEDERAL SAVINGS BANK	BALDWIN	NY	-5.7	5.1	476.0	465.2
8085	15	15	1	BEDFORD SA	BEDFORD	TX	-43.1	-43.1	71.9	71.9
8591	90	90	1	BENJAMIN FRANKLIN FSA	HOUSTON	TX	-412.2	-412.2	1838.0	1838.0
8289	12	12	1	BEXAR SAVINGS ASSOCIATION	SAN ANTONIO	TX	-402.1	-402.1	544.1	544.1
8633	6	6	1	BLACK HAWK S & LA, FA	ROCK ISLAND	IL	-1.4	-1.4	64.9	64.9
650	24	24	1	BLUE VALLEY FS & LA	KANSAS CITY	MO	-148.1	-148.1	680.7	680.7
7731	39	39	1	BRICKELLBANC SA	MIAMI	FL	-10.1	-10.1	35.3	35.3
6277	87	45	1	BRIGHT BANC SA	DALLAS	TX	-1219.9	-961.5	2832.2	2573.8
8639	78	36	1	BROADVIEW FEDERAL SAVINGS BANK	CLEVELAND	OH	-71.9	-60.8	1383.2	1372.1
8705	63	3	1	BROOKSIDE FS & LA	LOS ANGELES	CA	-24.0	-24.0	551.8	551.8
8631	12	12	1	CABRILLO FEDERAL SAVINGS BANK	HAYWARD	CA	-2.3	-2.3	50.9	50.9
8615	12	12	1	CAPITAL FS & LA	LITTLE ROCK	AR	-10.4	-10.4	77.6	77.6
759	84	84	0	CAPITAL-UNION SAVINGS FA	BATON ROUGE	LA	-51.1	-10.8	398.0	357.7
8608	90	15	1	CAPITOL CITY FSA	AUSTIN	TX	-102.3	-102.3	408.6	408.6
1777	0	0	0	CAPITOL FS & LA OF DENVER	AURORA	CO	-49.4	-48.7	1077.6	1076.9
8624	51	9	1	CAPROCK FS & LA	LUBBOCK	TX	-228.5	-228.5	342.7	342.7
2769	78	78	1	CASS FS & LA OF ST LOUIS	FLORISSANT	MO	-14.7	-14.7	46.4	46.4
8622	18	18	1	CENTENNIAL FS & LA	GREENVILLE	TX	-24.2	-24.2	52.5	52.5
4153	96	96	0	CENTRAL FEDERAL SAVINGS FSB	LONG BEACH	NY	-66.9	-40.8	921.1	895.0
7514	84	33	1	CENTRAL S & LA	JACKSON	MS	-24.8	-24.2	48.1	47.5
8605	72	72	1	CENTRAL S & LA, FA	NEW ORLEANS	LA	-21.8	-21.8	49.2	49.2
5347	78	78	1	CENTRAL TEXAS S & LA	WACO	TX	-63.9	-56.4	171.7	164.2
2745	72	12	0	CENTRUST BANK, A STATE SAVINGS BANK	MIAMI	FL	-195.0	179.2	8217.6	7843.4
5242	60	60	0	CENTURY FEDERAL SAVINGS BANK	CHICAGO	IL	-1.0	2.0	28.1	25.1
3946	63	12	1	CENTURY FEDERAL SAVINGS BANK	TRENTON	TN	-14.9	-14.9	58.4	58.4
4113	[illegible]	[illegible]	0	CERTIFIED SA	GEORGETOWN	TX	-22.1	-16.9	118.9	113.6
4855	84	84	0	CHAMPION FS & LA	BLOOMINGTON	IL	-17.6	89.6	2607.5	2500.3
360	90	90	0	CHARTER FEDERAL SAVINGS BANK	BRISTOL	VA	-15.9	33.7	1022.4	973.9
8009	[illegible]	0	0	CHARTER FS & LA	STAMFORD	CT	-0.3	-0.0	108.4	108.4
7608	[illegible]	[illegible]	0	CHARTER SAVINGS BANK	NEWPORT BEACH	CA	[illegible]	11.8	331.4	313.3
[illegible]	[illegible]	[illegible]	[illegible]	CHILLICOTHE FS & LA	CHILLICOTHE	[illegible]	[illegible]	[illegible]	[illegible]	29.6
[illegible]	[illegible]	[illegible]	[illegible]	CITIZENS FEDERAL SAVINGS BANK	OUT-OF-DISTRICT-CITY	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
8602	34	45	[illegible]	CITIZENS HOMESTEAD FSA	NEW ORLEANS	LA	[illegible]	[illegible]	[illegible]	99.0
[illegible]	[illegible]	[illegible]	[illegible]	CITIZENS [illegible]	LIMA	OH	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	42	[illegible]	CITIZENS OF TEXAS S & LA	BAYTOWN	TX	[illegible]	[illegible]	[illegible]	60.1

8653	72	72	1	CITIZENS S & LA OF SPRINGFIELD FA	SPRINGFIELD	IL	-4.7	-4.7	78.4	78.4
7347	72	72	1	CITY FEDERAL S & LA	OAKLAND	CA	-10.9	-10.9	18.7	18.7
4929	54	54	1	CITY FS & LA	BIRMINGHAM	AL	-55.5	-55.5	492.4	492.4
7871	45	45	1	CITY SA	LEAGUE CITY	TX	-17.0	-17.0	27.6	27.6
8734	90	3	1	CITY SAVINGS BANK, FSB	ELIZABETH	NJ	-805.1	-805.1	8502.5	8502.5
1981	78	78	1	CIVIC SAVINGS BANK	PORTSMOUTH	OH	-7.5	-6.3	74.5	73.3
3502	90	90	0	CLYDE FS & LA	NORTH RIVERSIDE	IL	-25.8	-11.1	574.7	560.0
8693	96	6	1	COLONIAL FEDERAL SAVINGS ASSOCIATION	ROSELLE PARK	NJ	-48.5	-48.5	368.5	368.5
5147	90	90	0	COLONIAL FS & LA	CAPE GIRARDEAU	MO	-12.6	-12.6	171.5	171.5
6547	63	63	0	COLONIAL SAVINGS, A FA	PRAIRIE VILLAGE	KS	-14.7	-14.7	136.4	136.4
371	90	3	0	COLONY SAVINGS BANK, FSB	MONACA	PA	-13.6	-13.6	451.4	451.4
7623	15	15	1	COLORADO S & LA	ENGLEWOOD	CO	-17.4	-17.4	36.0	36.0
8669	15	15	1	COLORADO SAVINGS BANK, FSB	STERLING	CO	-1.5	-1.5	10.1	10.1
8679	24	24	1	COLUMBIA FEDERAL HSTD ASSOCIATION	METAIRIE	LA	-9.3	-9.3	82.0	82.0
6927	45	45	1	COLUMBIA FEDERAL SAVINGS BANK	WESTPORT	CT	-28.5	-28.5	120.6	120.6
8700	[illegible]	3	1	COLUMBIA FSA	NASSAU BAY	TX	-1.3	-1.3	74.3	74.3
4071	63	63	0	COLUMBUS FSB	COLUMBUS	NE	-0.5	-0.5	101.7	101.7
6298	30	30	1	COMMERCE SA	SAN ANTONIO	TX	-301.6	-301.6	539.0	539.0
5190	30	30	0	COMMERCIAL FS & LA	OMAHA	NE	-7.0	129.0	5937.0	5801.0
8612	12	12	1	COMMERCIAL S & LA, FA	HAMMOND	LA	-6.9	-6.9	68.6	68.6
8550	6		1	COMMONWEALTH FEDERAL SA	HOUSTON	TX	-787.6	-787.6	1614.2	1614.2
8620	12	12	1	COMMONWEALTH FS & LA	MARGATE	FL	-163.0	-163.0	1007.7	1007.7
7306	78	66	1	COMMONWEALTH S & LA	OSCEOLA	AR	-10.0	-10.0	29.7	29.7
8707	96	12	1	COMMUNITY FEDERAL SAVINGS ASSOCIATION	BRIDGEPORT	CT	-1.3	-1.3	55.0	55.0
7567	90	90	1	COMMUNITY FS & LA	NEWPORT NEWS	VA	-1.4	-1.4	9.1	9.1
2403	84	84	0	COMMUNITY FS & LA	ST LOUIS	MO	-464.0	-464.0	3003.5	3003.5
7163	54	54	1	COMMUNITY FS & LA	TAMPA	FL	-11.2	-11.2	6.4	6.4
2410	24	24	1	COMMUNITY S & LA	FOND DU LAC	WI	-19.7	-19.7	141.4	141.4
6338	66	66	0	COMMUNITY SAVINGS BANK	EAST MOLINE	IL	-4.5	-3.7	112.0	111.2
3366	90	90	1	CONCORDIA FEDERAL BANK FOR SAVINGS	LANSING	IL	-70.3	-70.3	375.3	375.3
8604	15	15	1	CONTINENTAL FS & LA, FA	OKLAHOMA CITY	OK	-107.0	-107.0	528.4	528.4
8532	30	30	1	CONTINENTAL SAVINGS, A FS & LA	BELLAIRE	TX	-461.4	-461.4	221.8	221.8
8584	9	9	1	CORNERSTONE FSA	HOUSTON	TX	-16.1	-16.1	85.0	85.0
8697	3		1	CREST FS & LA	KANKAKEE	IL	0.2	0.2	126.4	126.4
8627	6	6	1	CROSS ROADS FS & LA, FA	CHECOTAH	OK	-8.5	-8.5	13.8	13.8
1806	90	90	0	CUSTER FS & LA	BROKEN BOW	NE	-0.6	-0.6	52.8	52.8
7589	90	0	0	CYPRESS BANK, FSB	PITTSBURG	TX	-0.2	0.3	31.5	31.1
7482	15	15	1	DEEP EAST TEXAS SA	JASPER	TX	-8.2	-8.2	45.3	45.3
7538	39	39	1	DELTA FS & LA	DREW	MS	-5.8	-5.8	6.1	6.1
6621	[illegible]	24	1	DELTA FS & LA	KENNER	LA	-51.2	-51.2	133.9	133.9
9659	[illegible]	6	1	DENTON FS & LA	DENTON	TX	-16.1	-16.1	140.2	140.2
7876	[illegible]	3	0	DEPOSIT TRUST SAVINGS BANK	MONROE	LA	-3.1	-3.1	98.0	98.3
8677	66	66	1	DESERET S & LA, FA	SALT LAKE CITY	UT	-92.9	-92.9	130.1	130.1
3253	90	90	1	DURAND FS & LA	DURAND	WI	-38.9	-38.9	80.4	80.4
5731	84	84	0	DUVAL FS & LA	JACKSONVILLE	FL	-54.9	-11.6	1016.3	973.0
8661	9	9	1	EAST TEXAS S & LA, FA	TYLER	TX	-33.3	-33.3	287.9	287.9
3671	96	96	0	EASTERN FS&LA OF SAYVILLE	SAYVILLE	NY	-10.3	-10.3	294.2	294.2
4087	69	0	0	EDGAR COUNTY S & LA	PARIS	IL	-0.1	-0.1	74.9	74.9
78	33	33	0	EL PASO FS & LA	EL PASO	TX	-20.4	21.8	402.9	440.7
7133	18	18	1	ELYSIAN FEDERAL SAVINGS BANK	HOBOKEN	NJ	-15.4	-15.4	117.7	117.7
5160	90	90	0	EMPIRE OF AMERICA FSB	BUFFALO	NY	-906.4	-949.4	8173.6	8126.6
2029	42	42	0	EMPORIA FEDERAL SAVINGS BANK	EMPORIA	VA	-0.1	-0.1	36.6	36.6
7966	84	84	0	ENSIGN BANK, FSB	NEW YORK	NY	-143.6	2.6	1809.3	1742.8
8053	0	0	0	ENTERPRISE FS & LA	CLEARWATER	FL	-0.9	-0.9	65.5	65.5
3418	90	78	0	ENTERPRISE SAVINGS BANK, FA	CHICAGO	IL	-47.0	-15.3	531.4	499.4
4379	42	42	1	EQUITABLE FSB	FREMONT	NE	-23.7	-23.7	198.9	198.9
6728	78	78	0	EQUITABLE S & LA, F.A.	COLUMBUS	NE	-2.4	-2.4	73.2	73.2
5776	63	42	1	EQUITY FSB	DENVER	CO	-1.4	-1.4	3.3	3.3
6222	18	18	1	EXCEL BANC SAVINGS ASSOCIATION	LAREDO	TX	-40.4	-40.4	104.5	104.5
1139	72	72	0	FAIRMONT FS & LA	FAIRMONT	MN	-2.3	-2.3	46.0	46.0
2289	84	3	0	FAIRVIEW FS & LA	ELLICOTT CITY	MD	-1.3	-1.3	121.8	121.8
7071	27	27	0	FALLS FS & LA	INTERNATIONAL FALLS	MN	-0.2	-0.2	8.5	8.5
2514	60	60	0	FAMILY FS & LA	DALLAS	OR	-4.9	-4.9	164.2	164.2
7804	108	15	1	FAMILY FS & LA	SHREVEPORT	LA	-6.7	-6.7	22.4	22.4
5251	54	6	0	FAMILY S & LA	LOS ANGELES	CA	-0.6	-0.3	138.0	137.7
8676	15	15	1	FAMILY SAVINGS BANK, FSB	SAPULPA	OK	-2.4	-2.4	49.7	49.7
3091	90	90	0	FAR WEST FEDERAL BANK,S B	PORTLAND	OR	-280.0	22.6	3672.8	3370.2
8614	57	57	1	FEDERAL SA OF THE SOUTHWEST	KILGORE	TX	-7.2	-5.1	34.7	32.6
8690	84	84	1	FIDELITY FEDERAL SAVINGS ASSOCIATION	GALESBURG	IL	-34.6	-34.6	360.4	360.4
8683	84	21	1	FIDELITY FEDERAL SAVINGS ASSOCIATION	PORT ARTHUR	TX	-89.7	-89.7	207.5	207.5
8061	78	42	1	FIDELITY FSB	CORINTH	MS	-77.4	-77.4	74.6	74.6
480	96	96	0	FIDELITY NEW YORK FSB	FLORAL PARK	NY	-29.5	61.1	1937.4	1846.8
2441	84	12	0	FIDELITY S & LA OF DANVILLE	DANVILLE	IL	-0.6	-0.6	16.3	16.3
2488	[illegible]	51	1	FINANCIAL FS & LA	JOPLIN	MO	-47.7	-47.7	137.8	137.8
8164	[illegible]	3	0	FINANCIAL S & LA	FRESNO	CA	-3.3	-3.3	31.2	31.2
[illegible]	[illegible]	[illegible]	[illegible]	FINANCIAL SECURITY FS & LA	DELRAY BEACH	FL	[illegible]	[illegible]	104.9	104.9
[illegible]	[illegible]	84	0	FIRST AMERICA FEDERAL SAVINGS BANK	FORT SMITH	AR	[illegible]	[illegible]	476.4	466.7
[illegible]	[illegible]	84	0	FIRST AMERICAN SAVINGS BANK, F.S.B.	GREENSBORO	NC	[illegible]	-1.9	[illegible]	882.6
[illegible]	[illegible]	90	0	FIRST ANNAPOLIS SAVINGS BANK, FSB	ANNAPOLIS	MD	[illegible]	6.9	[illegible]	[illegible]
[illegible]	[illegible]	90	[illegible]	[illegible] S & LA	PLAINFIELD	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

5893	34	19	0	FIRST BANKERS TRUST & SA	MIDLAND	TX	-3.3	3.3	110.1	106.7
6995	84	84	0	FIRST CITIZENS FS & LA	FORT PIERCE	FL	-16.0	-16.0	209.9	209.9
8600	24	24	1	FIRST CITY FS & LA	BATON ROUGE	LA	-5.0	-5.0	18.3	18.3
8625	39	39	1	FIRST EQUITY SAVINGS ASSOCIATION, FA	TOMBALL	TX	-64.9	-64.9	73.2	73.2
6020	24	24	1	FIRST FEDERAL BANK OF ALASKA, SB	ANCHORAGE	AK	-105.2	-105.1	122.2	122.2
8725	66	0	1	FIRST FEDERAL SAVINGS BANK	DIAMONDVILLE	WY	-0.4	-0.4	21.1	21.1
3073	0	0	0	FIRST FEDERAL SAVINGS BANK	LUBBOCK	TX	-0.0	-0.0	230.7	230.7
4592	84	84	0	FIRST FEDERAL SAVINGS BANK	WILMINGTON	DE	-7.0	10.0	323.1	306.1
3975	84	84	0	FIRST FEDERAL SAVINGS BANK OF HANOVER	HANOVER	PA	-3.9	0.5	77.2	72.8
141	78	24	1	FIRST FS & LA	ATLANTA	GA	-30.1	-30.1	187.1	187.1
924	90	90	1	FIRST FS & LA	BAKERSFIELD	CA	-11.2	-11.2	117.6	117.6
6100	63	63	1	FIRST FS & LA	BATON ROUGE	LA	-21.2	-21.2	37.2	37.2
2549	54	48	0	FIRST FS & LA	BELZONI	MS	-0.1	-0.1	5.1	5.1
7091	66	66	0	FIRST FS & LA	BREAUX BRIDGE	LA	-0.6	-0.6	20.7	20.7
7163	42	42	1	FIRST FS & LA	EUNICE	LA	-4.4	-4.4	14.5	14.5
5724	84	84	1	FIRST FS & LA	FAYETTEVILLE	AR	-21.7	-18.9	107.2	104.3
6016	60	60	0	FIRST FS & LA	GREENWOOD	MS	-2.1	-2.1	26.7	26.7
6596	84	84	1	FIRST FS & LA	LARGO	FL	-97.9	-97.9	272.8	272.8
3100	66	66	0	FIRST FS & LA	LAS VEGAS	NM	-0.4	1.5	59.9	58.0
376	51	51	0	FIRST FS & LA	MT VERNON	OH	-0.9	-0.9	77.9	77.9
3281	9	9	0	FIRST FS & LA	NEW BRAUNFELS	TX	-4.1	-0.0	235.6	231.5
6345	21	21	1	FIRST FS & LA	NEW IBERIA	LA	-8.8	-8.8	56.5	56.5
25	90	90	1	FIRST FS & LA	SHREVEPORT	LA	-71.1	-71.1	174.7	174.7
6090	42	42	1	FIRST FS & LA	SUMMERVILLE	GA	-6.1	-6.1	27.5	27.5
6582	0	0	0	FIRST FS & LA	WARNER ROBINS	GA	-1.5	-1.5	157.5	157.5
3400	72	72	0	FIRST FS & LA	WICHITA FALLS	TX	-3.9	-3.9	84.8	84.8
2941	72	72	0	FIRST FS & LA	WINNFIELD	LA	-1.2	-1.2	56.8	56.8
2638	60	60	0	FIRST FS & LA OF BISMARCK	BISMARCK	ND	-6.9	-6.9	113.4	113.4
8668	[illegible]	[illegible]	1	FIRST FS & LA OF BRENHAM	BRENHAM	TX	-23.0	-23.0	128.1	128.1
6702	3	3	0	FIRST FS & LA OF BROOKHAVEN	BROOKHAVEN	MS	-2.1	-2.1	42.8	42.8
8704	63	63	1	FIRST FS & LA OF CENTRAL INDIANA	ANDERSON	IN	-10.6	-10.6	183.9	183.9
2424	15	15	1	FIRST FS & LA OF COLORADO SPRINGS	COLORADO SPRINGS	CO	-106.6	-106.6	254.1	254.1
2659	18	18	0	FIRST FS & LA OF CONROE	CONROE	TX	-2.7	-2.7	178.9	178.9
1186	72	72	1	FIRST FS & LA OF EAST ALTON	EAST ALTON	IL	-6.1	-6.1	39.4	39.4
1263	69	0	0	FIRST FS & LA OF FARGO	FARGO	ND	-1.2	-1.2	57.4	57.4
3251	33	33	1	FIRST FS & LA OF HUTCHINSON	HUTCHINSON	KS	-54.8	-54.8	154.9	154.9
5698	0	0	0	FIRST FS & LA OF MACON CO	DECATUR	IL	-0.1	-0.1	64.4	64.4
3014	96	96	0	FIRST FS & LA OF PITTSBURGH	PITTSBURGH	PA	-107.9	91.5	3127.0	2927.5
2954	60	60	1	FIRST FS & LA OF SEMINOLE	SEMINOLE	OK	-4.4	-4.4	29.8	29.8
3422	84	50	0	FIRST FS & LA OF SEMINOLE CO	SANFORD	FL	-4.4	-4.4	215.4	215.4
259	78	78	1	FIRST FS & LA OF SOUTHEAST MO	CAPE GIRARDEAU	MO	-60.0	-60.0	274.2	274.2
5553	66	66	1	FIRST FS & LA OF THE FLORIDA KEYS	KEY WEST	FL	-56.8	-56.8	157.2	157.2
2817	63	[illegible]	0	FIRST FS & LA OF THIEF RIVER FALLS	THIEF RIVER FALLS	MN	-0.4	-0.4	56.7	56.7
6017	66	36	0	FIRST FS & LA OF YORK	YORK	NE	-2.4	-2.4	59.7	59.7
3187	78	78	1	FIRST FSB OF KANSAS	WELLINGTON	KS	-50.3	-50.3	125.0	125.0
7526	132	12	0	FIRST FSB OF NEW ORLEANS	METAIRIE	LA	-14.0	-13.0	167.0	166.0
392	69	0	0	FIRST FSB OF SOUTH DAKOTA	RAPID CITY	SD	-12.5	-9.0	344.1	340.6
8667	12	12	1	FIRST GARLAND FS & LA	GARLAND	TX	-17.7	-17.7	109.5	109.5
7588	96	6	0	FIRST GUARANTY BANK FOR SAVINGS	HATTIESBURG	MS	-16.5	-14.6	241.0	239.0
7289	90	90	0	FIRST JACKSON SAVINGS BANK, FSB	JACKSON	MS	-5.1	3.3	124.2	115.7
8691	69	54	1	FIRST LOUISIANA FSB, FA	LAFAYETTE	LA	-25.8	-25.8	142.6	142.6
8284	69	66	0	FIRST MINNESOTA SAVINGS BANK, FSB	MINNEAPOLIS	MN	-5.7	50.0	3151.3	3095.4
7974	27	0	0	FIRST NETWORK SAVINGS BANK	LOS ANGELES	CA	-2.5	-0.4	416.5	414.4
8626	27	27	1	FIRST OF KANSAS SAVINGS, A FS & LA	HAYS	KS	-5.1	-5.1	40.7	40.7
1329	51	51	0	FIRST S & L CO	MASSILLON	OH	-7.2	-3.2	167.9	163.9
5327	63	63	0	FIRST S & LA	BORGER	TX	-5.1	-5.1	65.5	65.5
8599	15	15	1	FIRST S & LA, FA	WACO	TX	-65.9	-65.9	342.5	342.5
7486	39	39	1	FIRST SAVINGS ASSN OF SOUTHEAST TEXAS	SILSBEE	TX	-8.4	-8.4	50.0	50.0
5230	84	84	0	FIRST SAVINGS BANK OF ZION	ZION	IL	-1.7	1.4	82.8	79.7
1243	51	0	0	FIRST SAVINGS BANK & TRUST, FSB	KANSAS CITY	MO	-1.9	-1.5	26.1	25.6
8582	57	39	1	FIRST SAVINGS OF AMERICUS, A FS & LA	AMERICUS	GA	-4.5	-4.5	50.8	50.8
8643	34	84	1	FIRST SAVINGS OF ARKANSAS, FA	LITTLE ROCK	AR	-679.4	-679.4	1007.5	1007.5
8666	72	9	1	FIRST SAVINGS OF LAREDO, FA	LAREDO	TX	-13.7	-13.7	168.3	168.3
5647	36	36	1	FIRST SOUTH SA	PORT NECHES	TX	-318.7	-318.7	237.0	237.0
5476	84	84	0	FIRST STANDARD SAVINGS FA	FAIRMONT	WV	-5.0	1.7	77.6	70.9
8585	69	36	1	FIRST STATE FSA	SAN ANTONIO	TX	-205.8	-205.8	173.4	173.4
6401	45	45	1	FIRST STATE SAVINGS BANK, FSB	MOUNTAIN HOME	AR	-42.3	-42.3	83.1	83.1
7829	45	45	1	FIRST VENICE S & LA	VENICE	FL	-6.2	-6.2	51.5	51.5
7674	126		0	FIRST WESTERN FEDERAL SAVINGS BANK	RAPID CITY	SD	-0.1	1.3	19.0	17.6
4604	9	9	0	FIRSTCENTRAL BANK, A FSB	CHARITON	IA	-0.7	-0.7	112.8	112.8
1943	0	0	0	FLORIDA FEDERAL SAVINGS BANK	ST PETERSBURG	FL	-30.8	18.1	4657.5	4608.9
7747	114	30	1	FONTAINEBLEAU FEDERAL SAVINGS BANK	SLIDELL	LA	-17.0	-17.0	31.3	31.3
8724	24	24	1	FORTUNE FINANCIAL FS & LA	COPPERAS COVE	TX	-6.9	-6.9	87.7	87.7
8634	34	34	1	FOUNDERS FS & LA	LOS ANGELES	CA	-45.4	-45.4	111.5	111.5
[illegible]	36	36	0	FRANKLIN FEDERAL SAVINGS BANK	MORRISTOWN	TN	-3.2	4.9	105.6	[illegible]
[illegible]	[illegible]	[illegible]	0	FREEDOM FS & LA	COLUMBUS	OH	-25.6	[illegible]	260.4	[illegible]
8414	[illegible]	42	1	FRENCH MARKET HOMESTEAD, FSA	METAIRIE	LA	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	0	FRONTIER FINANCIAL	BELLEVILLE	IL	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	84	84	0	FULTON FEDERAL SAVINGS BANK	ATLANTA	GA	-54.[illegible]	20.9	[illegible]	[illegible]
[illegible]	14	14	0	FUTURE FEDERAL SAVINGS BANK	LOUISVILLE	KY	-15.[illegible]	[illegible]	[illegible]	[illegible]

9642	60	60	1	GATEWAY FEDERAL SAVINGS BANK	SAN FRANCISCO	CA	-68.8	-68.8	67.1	67.1
2442	78	78	0	GEM CITY S & LA	QUINCY	IL	-15.0	-3.7	290.4	279.1
2966	84	84	0	GEM SA	DAYTON	OH	-45.5	-11.5	1452.6	1418.6
2695	138		1	GENERAL FEDERAL SAVINGS BANK	MIAMI	FL	2.6	2.6	345.9	345.9
7469	12	12	1	GENERAL SA	HENDERSON	TX	-12.1	-12.1	40.5	40.5
5217	0	0	0	GERMANIABANK, A FSB	ALTON	IL	-1.4	2.3	809.1	805.3
7562	9	9	1	GERMANTOWN TRUST SAVINGS BANK	GERMANTOWN	TN	-14.4	-14.4	110.2	110.2
8610	45		1	GIBRALTAR S & LA, FA	ANNAPOLIS	MD	-5.9	-5.9	29.9	29.9
8688	48	27	1	GIBRALTAR SAVINGS BANK, FSB	SEATTLE	WA	-3.7	-3.7	1474.2	1474.2
8687	9	9	1	GIBRALTAR SAVINGS, FA	SIMI VALLEY	CA	-47.0	-47.0	7147.9	7147.9
7082	36	36	1	GILL SA	HONDO	TX	-1045.4	-1045.4	920.0	920.0
8020	66	18	1	GOLDEN CIRCLE SA, FSB	CORSICANA	TX	-1.3	-1.3	14.9	14.9
7460	63	63	1	GOLDEN TRIANGLE S & LA	BRIDGE CITY	TX	-44.9	-44.9	19.6	19.6
6482	84	84	0	GOLDOME SAVINGS ASSN	ST PETERSBURG	FL	-142.2	31.8	1678.7	1504.6
7700	54	54	0	GRAND PRAIRIE S & LA	STUTTGART	AR	-0.4	0.9	31.5	30.1
2605	84	21	0	GREAT AMERICAN FS & LA	OAK PARK	IL	-23.3	14.0	1013.2	975.9
8689	9	9	1	GREAT PLAINS SAVINGS ASSOCIATION, FA	WEATHERFORD	OK	-13.5	-13.5	93.6	93.6
8586	84	51	1	GREAT SOUTHERN FS & LA	SAVANNAH	GA	-123.9	-123.9	570.1	570.1
8476	42	42	0	GREAT WEST SB, F.S.B.	CRAIG	CO	-2.4	-0.4	37.0	34.9
8657	66	18	1	GUADALUPE S & LA, FA	KERRVILLE	TX	-0.9	-0.9	25.4	25.4
284	36		0	GUARANTY FEDERAL SAVINGS BANK	FAYETTEVILLE	NC	-2.1	-2.1	60.3	60.3
7852	90	42	0	GUARANTY FEDERAL SAVINGS BANK	WARNER ROBINS	GA	-1.4	1.4	33.3	30.6
4439	90	90	1	GUARANTY FS & LA	BIRMINGHAM	AL	-61.8	-61.8	294.2	294.2
8597	57	12	1	HALLMARK S & LA, FA	PLANO	TX	-70.0	-68.8	124.8	122.6
8060	0	0	0	HANSEN SAVINGS BANK	PALM BEACH GARDENS	FL	-0.0	4.4	86.1	81.6
6268	57	57	0	HANSEN SAVINGS BANK, SLA	EAST BRUNSWICK	NJ	-1.1	14.2	613.3	598.0
8497	72	45	0	HAVEN FS & LA	WINTER HAVEN	FL	-17.5	1.4	172.4	153.5
8649	3	[illegible]	1	HEARNE B & LA, FA	HEARNE	TX	-1.0	-1.0	25.2	25.2
3242	90	90	0	HEARTLAND FS & LA	MATTOON	IL	-3.1	5.6	152.0	143.3
538	3	3	0	HENDERSON HOME FS & LA	HENDERSON	KY	-2.0	-2.0	50.4	50.4
5634	90	90	1	HERITAGE FS & LA	MONROE	NC	-57.9	-57.9	214.0	214.0
3273	90	90	0	HERITAGE FSB	OMAHA	NE	-5.6	-0.4	225.0	219.8
5134	0	0	0	HERITAGE S & LA	LAMAR	CO	-1.9	-1.9	48.8	48.8
7649	84	84	0	HERITAGE SA	LANCASTER	PA	-1.1	-1.1	55.1	55.1
8658	18	18	1	HERITAGE SAVINGS ASSOCIATION, F.A.	JERSEYVILLE	IL	-0.8	-0.8	29.3	29.3
7103	84	84	0	HERITAGE SAVINGS BANK, FSB	RICHMOND	VA	-6.5	2.8	837.0	827.7
6761	78	78	1	HERITAGEBANC SA	DUNCANVILLE	TX	-59.1	-59.1	131.7	131.7
5269	39	39	0	HOME FEDERAL SAVINGS BANK	WORCESTER	MA	-29.6	-7.5	235.5	213.4
664	84	84	1	HOME FS & LA	MEMPHIS	TN	-26.5	-26.5	192.4	192.4
3745	84	84	0	HOME FS & LA	ROME	GA	-3.3	-3.3	174.3	174.3
2193	60	60	1	HOME FS & LA OF CENTRALIA	CENTRALIA	IL	-4.2	-4.2	36.7	36.7
3696	84	[illegible]	0	HOME OWNERS SAVINGS BANK F.S.B.	BOSTON	MA	-23.7	43.1	3622.8	[illegible]
4104	12	12	0	HOME PLAN S & LA	JOHNSTON	IA	-0.7	-0.7	33.3	[illegible]
2645	57	57	0	HOME S & LA	DEFIANCE	OH	-2.3	-2.3	209.5	[illegible]
8623	12	12	1	HOME S & LA, FA	NEW ORLEANS	LA	-2.9	-2.9	33.5	33.5
439	3		0	HOME SA	BELLEVUE	PA	-0.1	-0.1	7.8	7.8
2882	27	0	0	HOME SA OF KANSAS CITY, FA	KANSAS CITY	MO	-26.3	-6.1	3264.0	3243.8
8647	24	24	1	HOME SAVINGS BANK, F.S.B.	ANCHORAGE	AK	-41.8	-41.8	54.7	54.7
8654	84	84	1	HOME SAVINGS, A FS & LA	JOILET	IL	-17.7	-17.7	126.3	126.3
2521	90	12	0	HOME UNITY S & LA	LAFAYETTE HILL	PA	-12.3	1.4	884.5	870.8
[illegible]	84	48	0	HOMETOWN FEDERAL SAVINGS BANK	DELPHI	IN	-4.3	1.3	68.6	63.0
5150	72	72	0	HOMETOWN S&LA, FA	WINFIELD	IL	-2.4	0.6	47.5	44.5
687	78	78	0	HOMEWOOD FS & LA	HOMEWOOD	IL	-8.7	9.5	230.3	212.1
4124	33	33	0	HONFED BANK, A FSB	HONOLULU	HI	-24.5	46.6	3166.2	3095.1
2651	84	84	0	HORIZON FEDERAL SAVINGS BANK	WILMETTE	IL	-112.3	-11.8	1223.7	1123.2
4159	96	96	1	HORIZON FINANCIAL, FA	SOUTHAMPTON	PA	-313.2	-313.2	1931.8	1931.8
8299	63	63	1	HORIZON FS & LA	METAIRIE	LA	-134.3	-134.3	361.5	361.5
7846	27	0	0	HUNTINGTON S & LA	HUNTINGTON BEACH	CA	-0.6	-0.6	120.4	120.4
5560	84	84	0	ILLINI FS & LA	FAIRVIEW HEIGHTS	IL	-5.7	7.5	501.8	488.6
6798	84	15	1	ILLINOIS SAVINGS BANK, FA	PEORIA	IL	-6.6	-5.2	44.3	42.9
1761	0	0	0	IMPERIAL SAVINGS ASSOCIATION	SAN DIEGO	CA	-89.0	-23.1	9581.8	9515.7
7255	96	96	1	INDEPENDENCE FS & LA	BATESVILLE	AR	-249.4	-226.0	171.7	148.3
7634	42	3	0	INVESTMENT S & LA	WOODLAND HILLS	CA	-8.5	-8.5	247.8	247.8
7556	66	3	0	INVESTOR FEDERAL SAVINGS BANK	NASHVILLE	TN	-1.3	-1.3	81.1	81.1
4825	63	63	0	IRVING S&LA	PATERSON	NJ	-12.3	-11.4	257.2	256.3
3190	72	72	1	JASPER FS & LA	JASPER	TX	-37.6	-36.8	117.2	116.5
6882	48	48	1	JEFFERSON S & LA	BEAUMONT	TX	-51.7	-51.7	103.0	103.0
2959	6	6	0	JENNINGS FS & LA	JENNINGS	LA	-2.2	-2.2	54.5	54.5
5020	84	84	0	JERSEY SHORE S & LA	TOMS RIVER	NJ	-8.2	18.3	665.5	639.0
7018	30	30	0	KARNES COUNTY S & LA	KARNES CITY	TX	-10.5	-10.5	53.1	53.1
7670	63	39	1	LA HACIENDA SAVINGS ASSOCIATION	SAN ANTONIO	TX	-83.3	-81.6	57.9	56.2
8611	138	12	1	LAFAYETTE S & LA, FA	GRETNA	LA	-1.4	-1.4	24.3	24.3
2979	84	3	0	LAKELAND FEDERAL SAVINGS BANK	DETROIT LAKES	MN	-6.0	-6.0	79.6	79.6
3115	48	48	1	LANDMARK SAVINGS BANK,FSB	HOT SPRINGS	AR	-58.3	-58.3	115.5	115.5
3094	24	24	1	LIBERTY COUNTY FS & LA	LIBERTY	TX	-5.5	-5.5	41.3	41.3
[illegible]	[illegible]		0	LIBERTY FEDERAL SAVINGS BANK	RANDALLSTOWN	MD	-4.4	[illegible]	[illegible]	46.2
[illegible]	[illegible]	[illegible]	0	LIBERTY SAVINGS ASSOCIATION	HOUSTON	TX	-1.9	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	24	1	LIBERTYVILLE FS & LA	LIBERTYVILLE	IL	-15.0	-15.0	77.4	77.4
8674	[illegible]	[illegible]	1	LINCOLN FS & LA	MIAMI	FL	-43.5	-43.5	170.4	170.4
[illegible]	[illegible]	[illegible]	1	LINCOLN FS & LA	MT CARMEL	TN	[illegible]	[illegible]	56.7	[illegible]

8619	69	[illegible]	1	LINCOLN S & LA, FA	LOS ANGELES	CA	-1289.9	-1285.6	2906.3	2902.0
6686	[illegible]	9	0	LINCOLN-WAY FEDERAL SAVINGS BANK	NEW LENOX	IL	-1.6	3.5	76.0	70.9
8741	24	24	1	LOUISIANA SAVINGS ASSOCIATION, FA	LAKE CHARLES	LA	-43.2	-43.2	416.4	416.4
238	69	30	1	MADISON COUNTY FS & LA	GRANITE CITY	IL	-12.8	-12.8	109.9	109.9
7601	30	30	1	MADISON GUARANTY S & LA	AUGUSTA	AR	-26.7	-26.7	111.1	111.1
5608	72	0	0	MARION COUNTY MUTUAL L & BA	HANNIBAL	MO	-0.0	-0.0	63.1	63.1
3493	84	12	0	MARSHALL FS & LA	MARSHALL	TX	-3.0	-3.0	62.0	62.0
6877	84	12	0	MERABANK, A FEDERAL SAVINGS BANK	PHOENIX	AZ	-490.5	-150.0	6381.9	6041.5
126	66	66	0	MERCHANTS AND MECHANICS FS & LA	SPRINGFIELD	OH	-12.2	-11.1	271.9	270.9
6649	96	0	0	MERCURY S & LA	HUNTINGTON BEACH	CA	-33.2	-0.1	2158.8	2125.7
7784	63	48	1	MERIDIAN SAVINGS ASSOCIATION	ARLINGTON	TX	-469.2	-469.2	29.5	29.5
5907	54	54	1	MERITBANC SAVINGS ASSOCIATION	HOUSTON	TX	-162.3	-156.7	200.7	195.1
1421	30	30	1	MESA FS & LA OF COLORADO	GRAND JUNCTION	CO	-2.8	-2.8	104.3	104.3
8660	6	6	1	METROPOLITAN FINANCIAL FS & LA	DALLAS	TX	-78.9	-78.9	779.8	779.8
5248	72	72	1	METROPOLITAN FS & LA	DENVILLE	NJ	-8.4	-8.4	156.7	156.7
7363	63	63	1	MIAMI SAVINGS BANK	MIAMI	FL	-38.5	-25.8	114.9	102.1
8685	78	45	1	MID KANSAS S & LA, FA	WICHITA	KS	-32.1	-32.1	693.0	693.0
8589	60	60	1	MID MISSOURI S & LA, FA	BOONVILLE	MO	-13.5	-13.5	55.2	55.2
2359	78	78	0	MID-AMERICA FS & LA	COLUMBUS	OH	-60.5	11.8	1275.1	1202.8
985	33	33	1	MID-AMERICA FS & LA	PARSONS	KS	-9.6	-9.6	69.0	69.0
8655	27	27	1	MIDLAND-BUCKEYE SAVINGS, A FS & LA	ALLIANCE	OH	-29.0	-29.0	177.1	177.1
546	84	84	0	MIDWEST FEDERAL SAVINGS BANK	MINOT	ND	-99.2	-99.2	955.0	955.0
2998	69	66	1	MIDWEST FS & LA	NEBRASKA CITY	NE	-29.6	-29.6	112.7	112.7
168	69	66	1	MIDWEST HOME FSB	BELLEVILLE	IL	-14.2	-14.2	92.6	92.6
8574	69	66	1	MIDWEST SAVINGS ASSOCIATION, FA	MINNEAPOLIS	MN	-788.1	-788.1	2245.3	2245.3
354	90	90	1	MIDWESTERN SA	MACOMB	IL	-20.3	-13.6	89.8	83.1
7309	24	24	1	MISSION SA OF TEXAS	SAN ANTONIO	TX	-49.2	-49.2	50.6	50.6
8588	18	18	1	MISSOURI SAVINGS ASSOCIATION, FA	CLAYTON	MO	-45.7	-49.7	537.3	537.3
2337	42	42	1	MODERN FS & LA	GRAND JUNCTION	CO	-3.7	-3.7	56.0	56.0
5304	84	84	0	MORTON FS & LA	MORTON	IL	-5.6	1.1	163.1	156.4
490	63	63	0	MOULTRIE FEDERAL SAVINGS BANK	MOULTRIE	GA	-0.3	-0.3	68.1	68.1
8537	72	72	1	MOUNTAINWEST S & LA, A FS&LA	OGDEN	UT	-53.4	-53.4	171.2	171.2
8580	27	27	1	MURRAY FS&LA	DALLAS	TX	-346.5	-346.5	961.9	961.9
4809	78	0	0	MUTUAL AID S & LA	MANASQUAN	NJ	-3.0	-3.0	104.4	104.4
2482	6	6	0	MUTUAL B & LA	WEATHERFORD	TX	-1.1	-1.1	104.8	104.8
3688	84	84	0	MUTUAL FSB, A STOCK CORPORATION	ZANESVILLE	OH	-4.4	0.6	309.9	305.0
2947	78	78	0	NASSAU FS & LA	BROOKLYN	NY	-39.9	-9.2	296.8	266.1
5931	9	9	0	NASSAU S & LA	PRINCETON	NJ	-10.4	-9.0	313.1	311.6
64	5	0	0	NEW AGE FS & LA OF ST LOUIS	ST LOUIS	MO	-0.1	-0.1	10.1	10.1
6489	66	66	0	NEW ATHENS S & LA	NEW ATHENS	IL	-0.9	-0.9	30.4	30.4
8607	51	42	1	NEW BRAUNFELS S & LA, FA	NEW BRAUNFELS	TX	-34.1	-34.1	49.0	49.0
8598	84	63	1	NEW GUARANTY FS & LA	TAYLOR	MI	-14.5	-14.5	193.7	193.7
8331	84	45	0	NEW METROPOLITAN FS & LA	HIALEAH	FL	-18.7	-18.7	26.0	26.0
8616	78	66	1	NEW MEXICO FSA	ALBUQUERQUE	NM	-25.9	-25.9	197.4	197.4
8594	72	72	1	NORTH AMERICAN FSA	SAN ANTONIO	TX	-26.2	-26.2	68.6	68.6
7414	84	0	0	NORTH CAROLINA FS & LA	CHARLOTTE	NC	-22.1	-10.8	628.1	616.9
4636	96	96	1	NORTH JERSEY S&LA	PASSAIC	NJ	-104.3	-104.3	250.6	250.6
2363	63	63	0	NORTH TEXAS FS & LA	WICHITA FALLS	TX	-4.2	-4.2	98.7	98.7
7484	90	0	0	NOWLIN SA	NORTH RICHLAND HIL	TX	-18.6	-18.6	200.5	200.5
2264	66	66	0	NUTLEY SAVINGS BANK, SLA	NUTLEY	NJ	-3.4	-3.4	224.6	224.6
8603	27	27	1	OCCIDENTAL NEBRASKA SAVINGS BANK, FSB	OMAHA	NE	-132.9	-132.9	552.5	552.5
5679	90	6	0	OLD BOROUGH S&LA	TRENTON	NJ	-2.6	-2.6	149.9	149.9
982	90	90	0	OLYMPIC FEDERAL S & LA	BERWYN	IL	-92.7	23.5	1145.6	1029.4
948	12	12	1	OTERO SAVINGS, A FS & LA	COLORADO SPRINGS	CO	-163.5	-163.5	395.7	395.7
7272	108	36	1	PADRE FS & LA	CORPUS CHRISTI	TX	-15.0	-15.0	15.4	15.4
4545	84	84	0	PALISADE SAVINGS BANK, SLA	RIDGEFIELD PARK	NJ	-8.6	24.3	266.3	233.4
7840	15	15	0	PALO DURO S & LA	AMARILLO	TX	-4.6	-4.6	65.0	65.0
9617	120	12	1	PARISH FS & LA	DENHAM SPRINGS	LA	-1.6	-1.6	12.4	12.4
1195	90	90	0	PARK VIEW FS & LA	CLEVELAND	OH	-1.8	-1.8	252.0	252.0
3584	84	84	0	PELICAN HMSTD & SA	METAIRIE	LA	-225.3	-147.7	1687.1	1609.6
[illegible]	57	48	1	PEOPLES SAVINGS ASSOCIATION, FA	ST JOSEPH	MI	-11.4	-11.4	73.2	73.2
6249	9	9	0	PEOPLES B & LA OF OBLONG	OBLONG	IL	-0.0	-0.0	9.3	9.3
7508	90	36	1	PEOPLES FS & LA OF THIBODAUX	THIBODAUX	LA	-3.2	-3.2	18.4	16.4
8648	9	9	1	PEOPLES HERITAGE SAVINGS, A FS&LA	SALINA	KS	-388.2	-388.2	1248.6	1248.6
8684	60	30	1	PEOPLE'S HMSTD SAVINGS BANK, FSB	MONROE	LA	-43.6	-43.6	254.2	254.2
424	39	39	1	PEOPLES S & LA	PARSONS	KS	-12.2	-12.2	51.3	51.3
1470	9	9	1	PEOPLES S & LA FA	HAMPTON	VA	-1.2	-1.2	22.2	22.2
8609	48	6	1	PEOPLES S & LA, FA	STREATOR	IL	-12.9	-12.9	33.0	33.0
1278	84	84	0	PEOPLES SAVINGS BANK	ASHTABULA	OH	-3.4	8.5	297.4	285.5
6408	27	21	1	PERMIAN S & LA	KERMIT	TX	-1.9	-1.9	8.0	8.0
8439	36	36	1	PHENIX FS & LA, FA	PHENIX CITY	AL	-60.2	-60.2	118.8	118.8
5762	90	0	0	PIMA S & LA	TUCSON	AZ	-12.7	26.8	2734.1	2694.6
5942	90	90	0	PIONEER SAVINGS BANK	CLEARWATER	FL	-95.3	-4.8	1935.7	1845.2
8629	84	84	1	PIONEER SAVINGS, FA	PLYMOUTH	IN	-12.3	-12.3	73.9	73.9
[illegible]	[illegible]	[illegible]	1	PLANO S & LA, FA	PLANO	TX	-36.1	-36.1	247.1	247.1
[illegible]	[illegible]	[illegible]	1	PLATTE VALLEY SAVINGS, A FS & LA	GERING	NE	-126.7	-126.7	240.9	240.9
[illegible]	[illegible]	[illegible]	0	PROGRESSIVE FEDERAL SAVINGS BANK	NATCHITOCHES	LA	[illegible]	[illegible]	58.0	58.0
[illegible]	[illegible]	18	0	PROVIDENT FS & LA	CASPER	WY	[illegible]	[illegible]	244.9	244.9
9740	[illegible]	42	1	RED RIVER FS & LA	COUSHATTA	LA	[illegible]	[illegible]	10.4	10.4
249	[illegible]	[illegible]	0	REGENCY SAVINGS BANK, A FSB	NAPERVILLE	IL	-6.5	-6.5	336.0	336.0

[illegible]	69	15	0	REMINGTON SA	ELGIN	TX	-2.6	3.4	174.2	168.2
[illegible]	[illegible]	27	1	REPUBLIC BANK FOR SAVINGS, FA	JACKSON	MS	-61.8	-61.8	29.0	29.0
[illegible]	24	24	1	RESOURCE SA	DENISON	TX	-134.9	-128.5	387.2	382.0
7782	[illegible]	30	1	ROCKY MOUNTAIN SAVINGS, A FSB	WOODLAND PARK	CO	-5.8	-5.8	13.5	13.5
1999	57	57	0	ROYAL OAK FS & LA	RANDALLSTOWN	MD	-1.6	-1.6	30.2	30.2
7886	69	15	1	ROYAL OAK S & LA	MANTECA	CA	-2.6	-2.6	24.3	24.3
8602	15	15	1	ROYAL PALM FS & LA	WEST PALM BEACH	FL	-126.2	-126.2	420.3	420.3
2813	69	33	1	RUSK FS & LA	RUSK	TX	-17.0	-17.0	30.3	30.3
6371	33	33	1	SABINE VALLEY S & LA	CENTER	TX	-6.3	-5.5	29.5	28.7
8702	3	3	1	SALAMANCA FEDERAL SAVINGS ASSOCIATION	SALAMANCA	NY	-0.4	-0.4	29.2	29.2
8596	12	12	1	SAN ANTONIO SAVINGS ASSOCIATION, FA	SAN ANTONIO	TX	-479.1	-479.1	2208.7	2208.7
6321	90	0	0	SAN JACINTO SA	BELLAIRE	TX	-19.8	16.4	3319.9	3283.6
8646	66	66	1	SANDIA FEDERAL SAVINGS ASSOCTIION	ALBUQUERQUE	NM	-753.2	-691.7	612.9	551.4
2079	61	0	0	SANTA BARBARA S & LA	SANTA BARBARA	CA	-25.8	-25.8	4677.0	4677.0
7928	0		1	SARATOGA S & LA	SAN JOSE	CA	4.8	4.8	104.6	104.6
[illegible]	39	39	1	SAVERS SAVINGS ASSOCIATION, FSA	LITTLE ROCK	AR	-428.4	-428.4	565.6	565.6
7456	78	78	1	SAVINGS OF TEXAS ASSOCIATION	JACKSONVILLE	TX	-44.3	-44.3	49.8	49.8
8686	69	30	1	SEASONS FEDERAL SAVINGS BANK	RICHMOND	VA	-29.5	-29.5	206.2	206.2
8671	42	42	1	SECURITY FEDERAL SAVINGS ASSOCIATION	TEXARKANA	TX	-403.0	-403.0	163.0	163.0
8709	84	84	1	SECURITY FEDERAL SAVINGS, FSB	COLUMBIA	SC	-47.7	-46.2	711.5	709.9
3121	84	84	0	SECURITY FIRST FS & LA	DAYTONA BEACH	FL	-27.8	21.2	1115.1	1066.1
8644	78	78	1	SECURITY FS & LA	PEORIA	IL	-27.3	-27.3	234.4	234.4
5854	90	90	0	SECURITY FS & LA	RICHMOND	VA	-27.3	-2.1	341.6	316.4
8708	72	66	1	SECURITY FSA	GARDEN GROVE	CA	-4.6	-4.6	69.4	69.4
8606	72	72	1	SECURITY HOMESTEAD FSA	NEW ORLEANS	LA	-64.5	-64.5	513.0	513.0
6875	84	84	1	SECURITY S & LA	SCOTTSDALE	AZ	-570.8	-570.8	521.3	521.3
[illegible]	[illegible]	[illegible]	0	SECURITY SAVINGS BANK, FSB	CARLSBAD	NM	-8.2	-8.2	27.8	27.8
8065	[illegible]	[illegible]	0	SENTINEL S & LA	PHOENIX	AZ	-1.7	-1.7	174.9	174.9
[illegible]	78	78	0	SHADOW LAWN SAVINGS BANK, SLA	LONG BRANCH	NJ	-16.1	5.7	695.5	673.7
2485	57	57	1	SHAWNEE FS & LA	TOPEKA	KS	-11.9	-11.9	223.4	223.4
[illegible]	9	[illegible]	1	SIERRA S & LA, FA	BEVERLY HILLS	CA	-2.6	-2.6	34.6	34.6
8699	6	[illegible]	1	SILVER SAVINGS ASSOCIATION, FA	SILVER CITY	NM	-0.3	-0.3	30.8	30.8
6137	15	15	1	SKOKIE FS & LA	SKOKIE	IL	-98.4	-98.4	678.7	678.7
8690	3	3	1	SOONER FEDERAL SAVINGS ASSOCIATION	TULSA	OK	-89.3	-89.3	1429.7	1429.7
8620	36	36	1	SOUTH S & LA, FA	SLIDELL	LA	-31.4	-31.4	235.6	235.6
6632	45	45	1	SOUTHEAST TEXAS S & LA	WOODVILLE	TX	-2.2	-2.2	28.6	28.6
7593	42	42	1	SOUTHEASTERN SA	DAYTON	TX	-52.5	-52.5	65.1	65.1
6865	42	42	1	SOUTHMOST S & LA	BROWNSVILLE	TX	-43.8	-43.8	84.5	84.5
[illegible]	15	15	1	SOUTHSIDE FS & LA	AUSTIN	TX	-3.0	-3.0	46.6	46.6
8678	[illegible]	[illegible]	1	SOUTHWEST FS & LA	LOS ANGELES	CA	-99.0	-99.0	605.2	605.2
8626	[illegible]	[illegible]	1	SOUTHWEST S & LA, FA	PHOENIX	AZ	-374.7	-374.7	1749.8	1749.9
[illegible]	84	84	0	SOUTHWEST SA	DALLAS	TX	-271.4	-246.5	[illegible]	5489.2
8703	[illegible]	6	1	SOUTHWESTERN FSA	EL PASO	TX	-10.4	-10.4	120.5	120.5
8656	33	33	1	SPINDLETOP SAVINGS ASSOCIATION, FA	BEAUMONT	TX	-195.7	-195.7	152.4	152.4
6139	84	72	1	SPRING BRANCH S & LA	HOUSTON	TX	-85.8	-85.8	83.9	83.9
1497	66	66	0	ST ANTHONY FS & LA	CICERO	IL	-1.2	-1.2	36.7	36.7
[illegible]	[illegible]	[illegible]	0	ST CHARLES S & LA	ST CHARLES	IL	-8.9	-8.9	146.5	146.5
3308	[illegible]	[illegible]	0	ST LOUIS COUNTY FS & LA	DULUTH	MN	-0.0	-0.0	234.2	234.2
[illegible]	72	72	0	ST LOUIS COUNTY FS & LA OF FERGUSON	FERGUSON	MO	-4.8	-4.8	85.8	85.8
6314	24	24	0	STANDARD SA	HOUSTON	TX	-1.6	-1.6	13.5	13.5
1228	57	57	0	STATE FS & LA	TULSA	OK	-40.2	4.4	[illegible]	481.7
309	84	84	0	STATE HOME SA	BOWLING GREEN	OH	-3.7	13.0	[illegible]	306.6
[illegible]	[illegible]	[illegible]	1	STATE MUTUAL FS & LA	JACKSON	MS	-2.0	-2.0	7.7	7.7
8482	[illegible]	12	0	STATESMAN BANK FOR SAVINGS, FSB	WATERLOO	IA	-2.7	20.0	615.0	592.2
[illegible]	[illegible]	72	0	STERLING SAVINGS ASSN	SPOKANE	WA	-9.9	11.0	[illegible]	687.2
[illegible]	12	12	1	SUBURBAN SA	SAN ANTONIO	TX	-17.5	-17.5	36.5	36.5
[illegible]	78	78	0	SUMMIT FIRST FS & LA	SUMMIT	IL	-1.5	-1.5	60.5	60.5
7749	84	84	1	SUN COUNTRY SB OF NEW MEXICO, FSB	ALBUQUERQUE	NM	-40.9	-39.5	58.6	57.2
[illegible]	[illegible]	12	1	SUN S & LA	PARKER	CO	-115.9	-115.9	191.2	191.2
[illegible]	48	[illegible]	0	SUN SAVINGS BANK	FORT DODGE	IA	-0.2	0.4	[illegible]	23.8
[illegible]	[illegible]	33	1	SUN SA, F. A.	KANSAS CITY	KS	-50.4	-50.4	135.8	135.8
8590	12	12	1	SUN STATE S & LA, FSA	PHOENIX	AZ	-216.1	-216.1	825.8	825.8
[illegible]	56	[illegible]	0	SUNBELT SAVINGS FSB	DALLAS	TX	-7.9	1.0	9108.1	9099.2
2688	90	90	0	SUPERIOR FEDERAL BANK, FSB	FORT SMITH	AR	-16.4	16.4	764.5	731.7
[illegible]	84	84	0	SUPERIOR FEDERAL SAVINGS BANK	NACOGDOCHES	TX	-6.1	2.4	82.3	74.4
[illegible]	12	12	1	SURETY FEDERAL SAVINGS ASSOCIATION	EL PASO	TX	-21.1	-21.1	287.4	287.4
8459	72	72	0	SURETY FS & LA, FSA	MORGANTON	NC	-3.0	5.9	226.1	217.2
3557	0	0	0	SWEETWATER FS & LA	ROCK SPRINGS	WY	-0.2	-0.2	12.4	12.4
8650	9	9	1	TAYLORBANC FS & LA	TAYLOR	TX	-15.6	-15.6	129.6	129.6
[illegible]	90	[illegible]	0	TCF BANC SAVINGS ASSOCIATION	HOUSTON	TX	-7.8	5.5	23.6	10.4
[illegible]	84	[illegible]	1	TERREBONNE S & LA, FA	HOUMA	LA	-4.2	-4.2	24.7	24.7
5140	[illegible]	[illegible]	0	TEXAS S & LA	SAN ANTONIO	TX	-0.7	-0.7	59.0	59.0
[illegible]	[illegible]	[illegible]	1	TEXAS WESTERN FSA	OUT-OF-DISTRICT-CI	OK	-11.0	-11.0	98.0	98.0
[illegible]	[illegible]	[illegible]	0	TEXASBANC SAVINGS, FSB	CONROE	TX	-148.1	-147.4	[illegible]	248.1
[illegible]	[illegible]	[illegible]	1	THE BARBER COUNTY S & LA	MEDICINE LODGE	KS	-8.9	-8.9	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	THE BENJ. FRANKLIN FS & LA	PORTLAND	OR	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	1	THE DUNCAN S & LA	DUNCAN	OK	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	0	THE FIRST, FEDERAL ASSOCIATION	ORLANDO	FL	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	THE GARNETT S & LA	GARNETT	KS	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	THE GUARDIAN FS & LA	BAKERSFIELD	CA	[illegible]	[illegible]	[illegible]	[illegible]

[illegible]	60	0	0	THE HIAWATHA S & LA	HIAWATHA	KS	-7.2	-6.1	49.2	48.1
2811	96	96	0	THE LONG ISLAND S/B OF CENTEREACH FSB	CENTEREACH	NY	-239.7	248.8	2752.0	2263.5
6439	66	15	0	THE SAVINGS BANC, A S & LA	ARLINGTON	TX	-2.0	3.1	142.7	137.6
1223	90	90	0	THE TALMAN HOME FS & LA OF ILLINOIS	CHICAGO	IL	-209.8	331.6	6072.7	5531.3
7534	0	0	0	THE TENNESSEE SAVINGS BANK	COOKEVILLE	TN	-0.5	0.5	42.8	41.9
5	84	0	0	THE UNITED S&LA OF TRENTON NJ	TRENTON	NJ	-8.3	-8.3	294.7	294.7
7591	36	36	1	TIMBERLAND SA	NACOGDOCHES	TX	-7.8	-7.8	43.7	43.7
8447	39	39	1	TOPEKA SAVINGS, A FS & LA	TOPEKA	KS	-46.1	-46.1	73.4	73.4
8637	84	84	1	UNIFIRST BANK FOR SAVINGS, A FS & LA	JACKSON	MS	-123.7	-123.7	635.8	635.8
7617	51	51	1	UNIPOINT FEDERAL SAVINGS BANK	TRUMANN	AR	-16.1	-16.1	13.1	13.1
3058	78	78	0	UNITED FEDERAL SAVINGS BANK	WINDOM	MN	-9.3	-5.4	169.3	165.4
3228	60	0	0	UNITED FEDERAL SAVINGS BANK OF IOWA	DES MOINES	IA	-6.3	2.8	999.7	990.6
6997	63	0	0	UNITED FS & LA	NEW ORLEANS	LA	-0.4	-0.4	53.6	53.6
6650	84	0	0	UNITED FS & LA	SMYRNA	GA	-0.2	4.7	149.1	144.2
7512	60	60	1	UNITED GUARANTY FEDERAL SAVINGS BANK	TULLAHOMA	TN	-2.1	-2.1	7.0	7.0
3412	72	72	0	UNITED HOME FEDERAL	TOLEDO	OH	-9.6	-0.5	505.3	496.3
636	84	84	0	UNITED SAVINGS OF AMERICA	CHICAGO	IL	-57.8	60.5	1347.4	1229.1
8453	18	18	1	UNIVERSAL S & LA, A FS & LA	SCOTTSDALE	AZ	-21.9	-20.7	71.7	70.6
7213	36	36	1	UNIVERSAL SA	HOUSTON	TX	-203.7	-203.7	115.5	115.5
7722	3	3	0	UVALDE S & LA	UVALDE	TX	-2.9	-2.9	13.3	13.3
8682	6	6	1	VALLEY FEDERAL SAVINGS ASSOCIATION	MCALLEN	TX	-107.4	-107.4	482.8	482.8
8642	54	54	1	VALLEY FS & LA	GRAND JUNCTION	CO	-77.2	-77.2	57.9	57.9
7443	0	0	0	VALLEY FS & LA	VAN NUYS	CA	-28.1	-28.1	3015.4	3015.4
8645	45	45	1	VALLEY SAVINGS BANKS, FSB	ROSWELL	NM	-128.5	-128.5	132.6	132.6
8652	39	39	1	VALLEY SAVINGS, A FS & LA	HUTCHINSON	KS	-56.2	-56.2	164.8	164.8
3474	84	84	0	VANGUARD FEDERAL SAVINGS BANK	VANDERGRIFT	PA	-7.1	0.7	176.9	169.1
4177	84	84	0	VERMONT FS & LA	TIMONIUM	MD	-33.9	-17.7	334.9	318.7
8587	34	18	1	VICTORIA SAVINGS ASSOCIATION FSA	VICTORIA	TX	-239.8	-239.8	742.9	742.9
7830	102	6	0	VIKING SAVINGS ASSOCIATION, FA	ALEXANDRIA	MN	-0.9	-0.3	20.7	20.1
7592	27	27	1	VISION BANC SAVINGS ASSOCIATION	KINGSVILLE	TX	-45.8	-45.8	65.2	65.2
7835	18	18	1	WASHINGTON S & LA	STOCKTON	CA	-3.9	-3.8	69.4	69.2
6859	6	6	0	WASHINGTON SHORES SAVINGS BANK,FSB	ORLANDO	FL	-0.2	-0.2	9.2	9.2
845	69	66	0	WATAUGA S & LA	BOONE	NC	-2.0	-2.0	113.4	113.4
1737	57	57	1	WESTCO SAVINGS BANK, FSB	WILMINGTON	CA	-23.1	-14.3	139.3	130.5
8249	0	0	0	WESTCOAST S & LA	PACIFIC PALISADES	CA	-0.6	1.5	59.3	57.1
7853	24	0	0	WESTERN EMPIRE S & LA	YORBA LINDA	CA	-8.6	0.1	406.6	397.9
7489	48	48	1	WESTERN GULF S & LA	BAY CITY	TX	-164.6	-164.6	143.6	143.6
8579	12	12	1	WESTERN S & LA, FA	PHOENIX	AZ	-1412.6	-1412.6	4221.3	4221.3
7663	60	0	0	WESTPORT SAVINGS BANK	HANFORD	CA	-4.8	-4.8	169.6	169.6
7611	48	48	1	WESTWOOD S & LA	LOS ANGELES	CA	-247.8	-247.8	271.1	271.1
4925	90	90	0	WHITESTONE SAVINGS, FA	WHITESTONE	NY	-34.9	-34.9	396.9	396.9
7367	78	0	0	WILLIAMSBURG SAVINGS BANK	SALT LAKE CITY	UT	-21.4	-15.8	310.5	304.9
7979	69	0	0	WILSHIRE S & LA	LOS ANGELES	CA	-0.4	-0.4	78.1	78.1
1709	63	33	0	YANKTON S & LA	YANKTON	SD	-0.3	-0.3	35.8	35.8
8701	90	90	1	YORKRIDGE-CALVERT FSA	BALTIMORE	MD	-14.9	-14.9	539.5	539.5
5279	84	84	0	YORKWOOD S&LA	MAPLEWOOD	NJ	-10.7	-10.7	205.3	205.3

The **Chairman**. Let me at this point ask Senator Dixon if he has an opening comment that he wants to make, and then I will go to Senator D'Amato.

Senator **Dixon**. Well, I do have a comment, Mr. Chairman. Basically I ask unanimous consent and consent of the Chair that my statement be reproduced in the record in full, but I am delighted to hear what Mr. Barth has said, and I hope other witnesses are like minded, because I continue to believe that we need some kind of a risk-based deposit insurance system employing our Federal Deposit Insurance System in a cooperative effort with the private sector.

I think the essence of what Mr. Barth has said will develop in the question and answer period. It supports the view that I have, and I thank him for his statement.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the committee continues its hearings on deposit insurance reform. We have a good group of witnesses before us today; I know we will benefit greatly from their testimony.

I want to take this opportunity to make one point, which is that deposit insurance reform will require great changes in the way regulators approach and handle bank failures if it is to be a success. Currently, for example, the Federal Reserve Board can loan banks in trouble money from the discount window. The Fed always makes these loans on a secured basis—using good assets of the borrowing bank—but the result is that the uninsured depositors have a chance to leave, and the result of that is the Federal insurance fund bears a greater loss.

Now I understand that the Fed has legitimate concerns about the safety of our financial system, and that they want to avoid disorderly closure situations. However, I think we also need to worry about how we can build more market discipline into our financial system, how we minimize the risks to the insurance fund, and how we can reduce the size of any possible losses to the fund.

I think that meaningful reform must include incentives for earlier action by the regulators. We simply cannot allow institutions to operate for years and years after their capital is exhausted. We ought not allow an instituion to operate for a minute after its capital is gone.

I want to work with the regulators to develop sound and workable changes. I applaud their success in maintaining the stability of our financial system. Real reform, however, will require fundamental change, and that includes changes in the way the regulators now approach financial institutional failures.

The **Chairman**. Thank you, Senator Dixon.

Senator **D'Amato**. Mr. Chairman, I'm just going to ask that my statement be included in the record.

The **Chairman**. Without objection, we will make it a part of the record.

STATEMENT OF SENATOR D'AMATO

Mr. D'AMATO. Mr. Chairman, I commend you for assembling another distinguished panel of experts to help us devise the best model for our financial system.

Our country has reached a critical juncture in a world of increasing global competition for financial services. We have accustomed ourselves to a position of preeminence in the banking world; yet, over the past decade, this position has been challenged by Western Europe and Asia. Moreover, we have just suffered the greatest domestic banking crises since the 1930's.

We now face the crucial test: whether to restructure in a way that reinforces our strengths and avoids the pitfalls of the past; or to "muddle through" in our current, fragmented and inefficient financial system; or—worse yet—attempt to reconstruct a simpler and long-departed financial world. The decade of the 1990's may be our last opportunity to make the choices that will help ensure our position in the financial world.

We count on experts, such as those assembled here today, to help us redesign our financial system. Gentlemen, I thank you for appearing before us and look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Bryan.

STATEMENT OF LOWELL L. BRYAN, DIRECTOR, McKINSEY & CO., NEW YORK, NY

Mr. BRYAN. Thank you.

I'm going to try to devote my remarks today primarily to the commercial banking industry as opposed to the savings and loan industry, which I testified on the last time I was here.

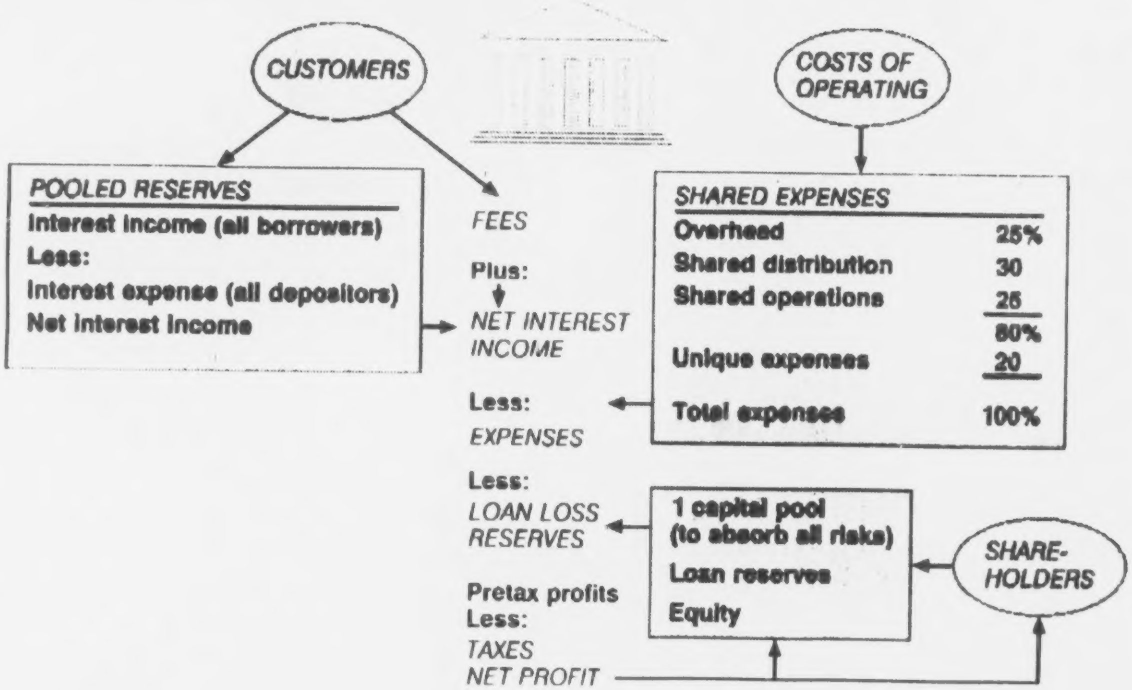
I think the fundamental problem is that we have a very bad combination of regulation and market forces at work right now and we have to reform our banking system fundamentally. I think not just the banking industry and thrifts have problems, but our economy is in trouble.

I would like to direct your attention to a series of charts which I'm going to use to illustrate some of my points. As a consultant I don't know how to get along without charts.

[exhibit 1.]

Exhibit 1

CONCEPTUAL MODEL OF BANK


CUSTOMERS
COSTS OF OPERATING
POOLED RESERVES
Interest income (all borrowers)
Less:
Interest expense (all depositors)
Net interest income
FEES
Plus:
NET INTEREST INCOME
Less:
EXPENSES
Less:
LOAN LOSS RESERVES
Pretax profits
Less:
TAXES
NET PROFIT
SHARED EXPENSES
Overhead 25%
Shared distribution 30
Shared operations 25
80%
Unique expenses 20
Total expenses 100%
1 capital pool (to absorb all risks)
Loan reserves
Equity
SHARE-HOLDERS

McKinsey&Company, Inc.

Mr. **Bryan**. Basically the model of a bank was developed sometime in the 1200's in Europe, and it's simply based upon being able to have a sufficient interest spread between what you pay for deposits and what you earn on loans to cover all your expenses and your costs of capital.

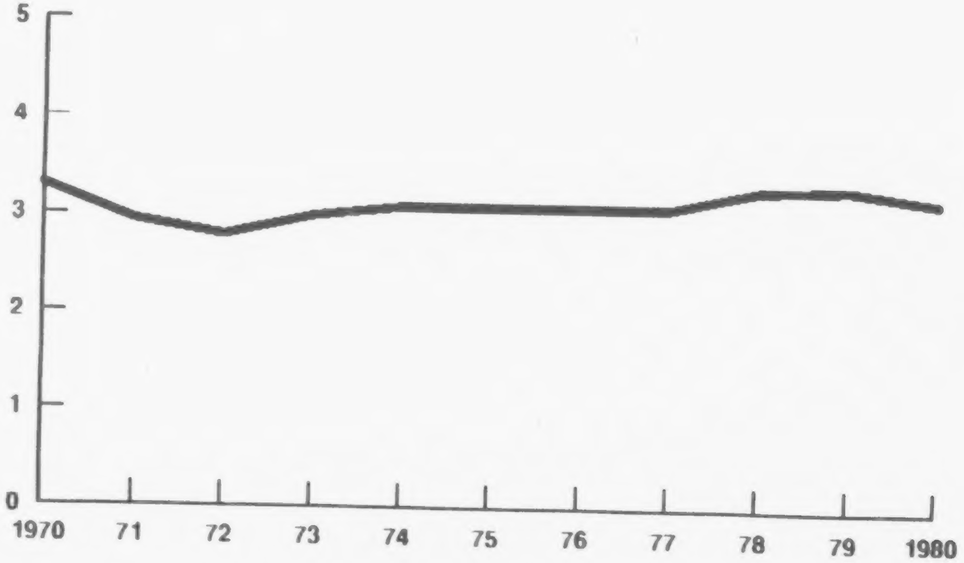
In almost all nations of the world the source of the profits comes from the deposit side. Now we have a problem in our country in that the source of profitability has disappeared.

[exhibit 2.]

Exhibit 2

NET INTEREST MARGIN 1970-80

For insured commercial banks



Source: FDIC Reports of Condition and Income; McKinsey analysis

McKinsey&Company, Inc.

Mr. BRYAN. Banks tend to operate, and have historically operated, as oligopolies. This chart is the net interest margin divided by assets, for the 1970's. The line shown on the chart is not a trend. The chart depicts a very flat line. The chart shows that the net interest margin for the entire industry was very constant during the entire 1970's, even though, as you recall, interest rates went all over the place during the 1970's.

The CHAIRMAN. If I may, just before you go by there, what is the inference you draw from that?

Mr. BRYAN. The inference is that the only way you get that kind of a chart is by having oligopolistic pricing at work. In fact, during the 1970's we had a system where we had a nation full of local oligopolies. I was a part of the industry. I was in Boston. We had a Boston price for everything, and there was a separate San Francisco price for everything as well.

What happens in an oligopoly, is you can pass along your costs. It's not a cartel, and it's not agreed upon prices. It's just de facto you're able to move prices around to get whatever net interest margin you need to cover your cost and your cost of capital.

The CHAIRMAN. Now just as another quick aside, if you were to look at a chart like this for say a public utility, and I don't know if you have a long background in public utilities, but might we not see lines similar to this?

Mr. BRYAN. Yes, and the tradeoff of course is that in the 1970's and before that we had an explicit tradeoff in the whole post-war environment. In exchange for regulation, you get safety and profitability. [exhibit 3.]

Now, unfortunately for banks, fortunately for their customers, oligopolistic pricing policies came to an end because market forces developed that were completely beyond anybody's control. Money market mutual funds were developed, and basically the source of the profitability of banks, the savers who were basically being exploited by inflation, left the system. There was no choice but in 1982 to accommodate those market forces and deregulate insured deposits.

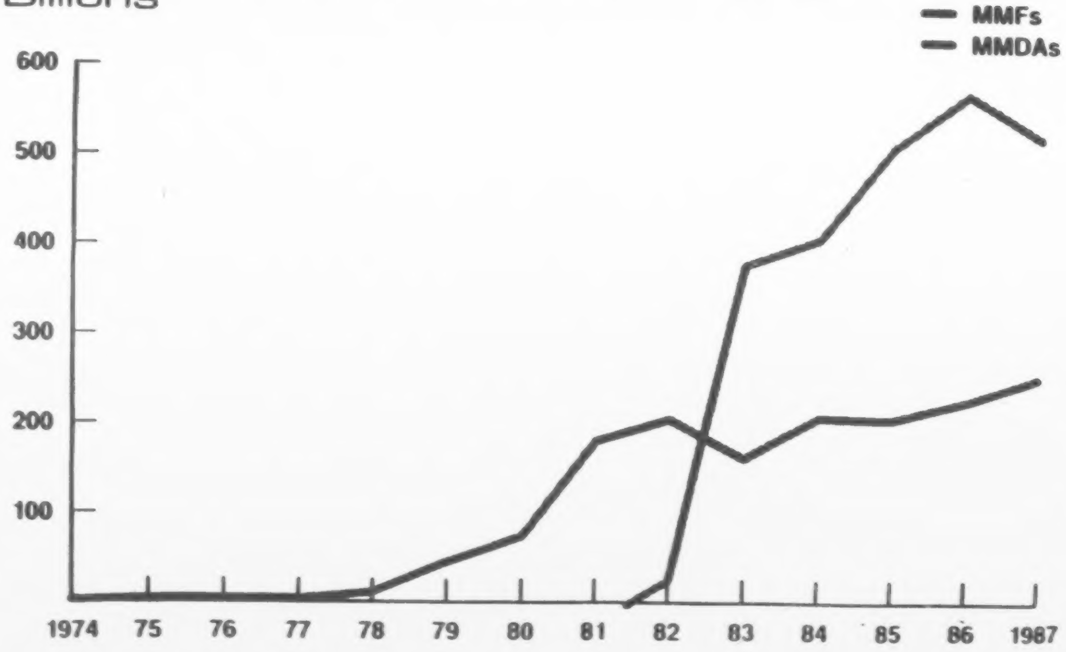
The problem was even though it was politically impossible at that time, we should have reformed the whole structure. It's also easier to say things with hindsight than with foresight. [exhibit 4.]

If you look at net interest margins for the industry, and this is for commercial banks during the 1980's, you see that in fact the net interest margin went up sightly. You're going to need to have good eye sight to see that. After charge-offs, however, the net interest margin declined slightly. In other words, to replace the oligopoly profits, commercial banks took more risk. [exhibit 5.]

Exhibit 3

MONEY MARKET FUNDS VS. MONEY MARKET DEMAND ACCOUNTS

$ Billions



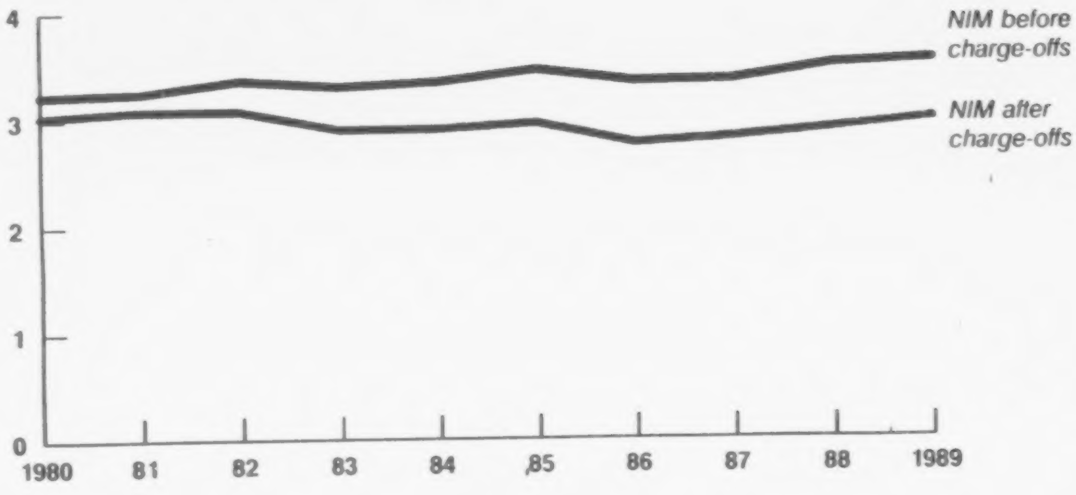
Source; FDIC Reports of Condition and Income; Investment Company Institute; McKinsey analysis

McKinsey&Company, Inc.

Exhibit 4

NET INTEREST MARGINS

Total commercial bank industry
1980-89
Percent of average assets

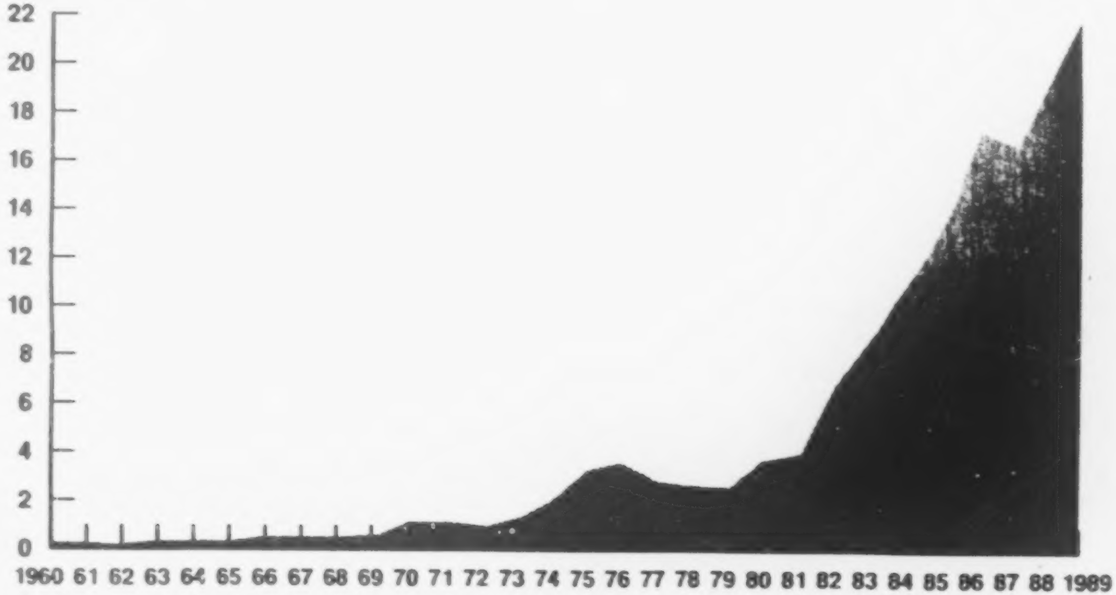


Source: FDIC Reports of Condition and Income; McKinsey analysis

Exhibit 5

COMMERCIAL BANKS: EVOLUTION OF NET CHARGE-OFFS 1960-89

$ Billions



Source: FDIC Reports of Condition and Income; McKinsey analysis

McKinsey&Company, Inc.

Mr. **Bryan**. And why this is important is when you take a look at those charge-offs, they actually get to be quite disturbing in their size. In the last 4 years, the commercial banking industry has charged-off over $70 billion of loan writeoffs.

To put that in perspective, from 1948 through 1981, the last year before we deregulated deposit pricing the entire charge-offs over the entire period were only $28 billion.

Now you also asked if I could make some comments about the safety and adequacy of the fund. You will notice, if you have good eye sight, that in 1969 and 1970 overall charge-off levels doubled in that year. We had a recession then. We had a recession in 1974 and 1975 and charge-offs doubled and they persisted for 2 years. We had a recession in 1979 and 1980 and charge-offs doubled. And then they continued to rise without a recession, except in Texas where you did have a regional recession.

If we were to have a recession today, I would bet that charge-offs would double, and they would go to $40 to $50 billion a year and persist after level for at least 2 years.

Since we also know actuarially that two-thirds of those charge-offs will be concentrated in less than 20 percent of the industry, if we were to have a recession and if we were to have that kind of a charge-off pattern, we would blow through the capital of those institutions and the bank insurance fund.

The **Chairman**. Now the bank insurance fund, before you move that, is right now at about $13 billion I think give or take. So you're saying that if we saw anything like a recession driven doubling of write-offs and because of the concentration in the banking industry that $13 billion wouldn't last very long.

Mr. **Bryan**. It wouldn't last very long because we find that uneconomic risk is concentrated in the weakest underwriters and therefore they are concentrated.

The **Chairman**. Now can you explain to us why—I mean I think it's important to have you elaborate a little bit. That's fine print on that chart, but it looks like it's about 1981 that we really start going up this very sharp incline. Talk a little bit about your sense from 1981 through the end of your chart there, which is——

Mr. **Bryan**. I think commercial banks had to replace the lost income from their deposit franchise to keep their business system whole.

Without restructuring actually the way they were operating, the easiest way out of profit pressure was to say that risk that looked not too bad yesterday looks a little better today. No one decided in the commercial bank industry to go wild. It's just to keep the earnings up, and under budget pressure and in an environment where your institution was taken over if you didn't have good enough earnings because your stock price wasn't high enough, the industry took more and more risk a little step at a time.

The **Chairman**. Now for commercial banks, what would have been the categorical areas where they were reaching for these higher risk projects of activities that gave us this higher charge-off.

Mr. **Bryan**. Well, the after-the-fact evidence is that in the early 1980's it was an LDC problem. In the late 1980's it was partially highly leveraged transactions. But the biggest problem by far was commercial real estate loans the same category of assets that got the savings and loan industry in such deep trouble.

The **Chairman**. Would commercial real estate loans be 70 percent of it?

Mr. **Bryan**. No. This is a broad category, and some of the increase in charge-off was from shifting loan unit to economically well underwritten activity such as credit cards. Credit cards have higher loan losses naturally but these losses are more than recovered through high-interest rates. So some of the shift in charge-off was a shift to retail assets. However, I think the problem that exists today is primarily on the wholesale assets side—commercial real estate and highly leverage transactions. Only in the last year or two would you see the real problems coming from commercial real estate. In the early days it wasn't though.

The **Chairman**. I want to invite my colleagues, too, if they have got questions along here to get into this as we go.

Senator **D'Amato**. Thank you, Mr. Chairman. Wouldn't there be fee-driven loans, in other words, where they are going to able to book that profit and show it——

Mr. **Bryan**. Most of the problems were fee-driven loans, yes.

The **Chairman**. It's front-end fees.

Mr. **Bryan**. You front-end the income and the loan losses come later, and it's the weakest underwriters in the industry that book the most of these loans because they have the most earnings problems they are having the most difficulty competing.

Senator **D'Amato**. You are seeing some of them do it even now. In the real estate market that has collapsed, you wonder how you see these structures going up and who is going to buy them. I see these condos in certain areas, and I won't be too specific, but today in regions where there are none being sold, and they broke ground on this one job about 8 or 9 months ago, and you say, my God, what institution would be loaning them this money. It's maddening, you now, and I wonder. This guy is going to get stuck. He is not going to get stuck. They are going to have a $30 or $40 million hole.

Mr. **Bryan**. What I am trying to stress is that in fact it's an economically driven problem so that we have to fundamentally reform the system. It's not a matter of better enforcement. We have an economic problem on our hands, and the economics of the banking industry is a large part of the problem.

I'm going to run out of time. [exhibit 6.]

The **Chairman**. I know. Go ahead.

Mr. **Bryan**. The thrift industry is a significant part of the problem. I got out of the business of estimating thrift losses. About 3 years ago I was estimating $100 billion and other people had lower estimates. The numbers are very large today, and I suspect it will be considerably more than the current plans account for. I do not have a new estimate, but it's going to be a very large number.

The **Chairman**. Now what is the relevance of this chart then?

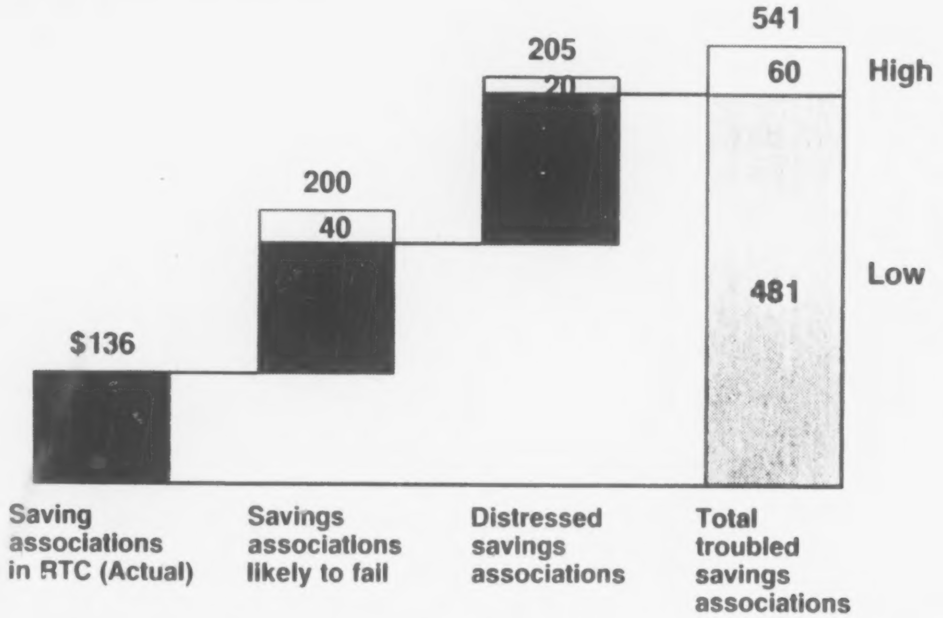
Mr. **Bryan**. The only relevance of this chart is that the problems in commercial banks are coming when the Nation is still coming to grips with a massive thrift problem. We may also have massive losses as well. What this chart says basically, is that we have $550 billion of assets in distressed thrifts right now, and of course the liabilities are more than that. The problem is the Government doesn't own the liabilities. It owes people for the liabilities, but in fact it's going to own these assets, and there is not a good market for most of these assets and the economic loss is very large as a result.

And whether the number is $100 billion or $200 billion or some other very large number, it is a number large enough to stretch the resources of the Nation and we need to do whatever we can do to get through the problem as best we can. But the S&L crisis is not the issue we're talking about today. However, I believe we need to get rid of the capacity of these in solved institutions in order to make the remaining depository system whole. [exhibit 7.]

Exhibit 6

TROUBLED SAVINGS ASSOCIATIONS

$ Billions of assets



Source: Resolution Trust Corporation; McKinsey analysis

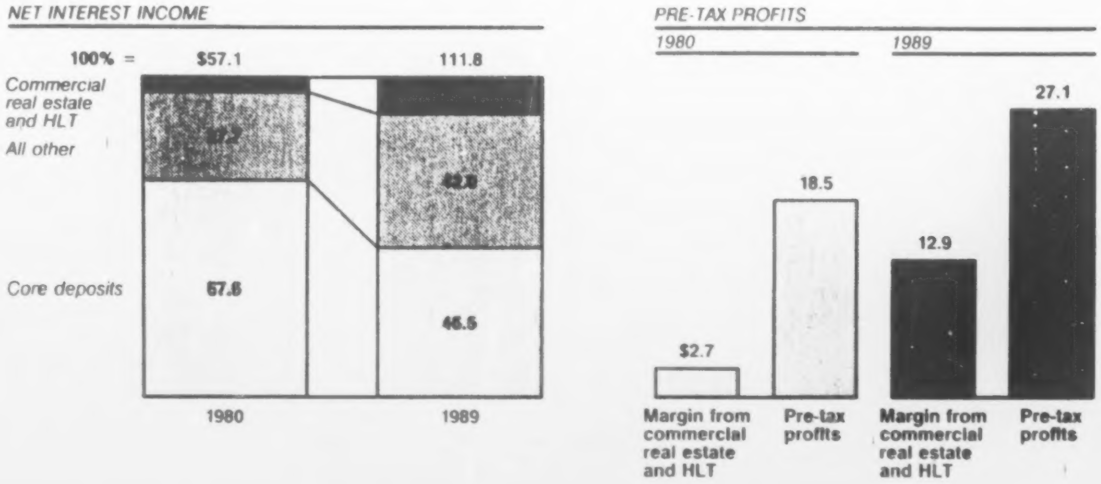
McKinsey&Company, Inc.

Exhibit 7

CONTRIBUTION TO NET INTEREST INCOME AND PRE-TAX PROFITS

$ Billions

ESTIMATE



Source: FDIC Reports of Condition and Income; McKinsey analysis

McKinsey&Company, Inc.

Mr. BRYAN. To get to the Senator's point, in 1980 we estimate that two-thirds of the banking industry's income came from core deposits, from the earnings it was making on savings accounts and checking accounts. In contrast, that is down to 45 percent today, and lot of what has replaced it has been real interest income from commercial real estate and highly leveraged transaction loans.

Our estimate is that in 1980 the margin from commercial real estate and highly leveraged transactions was $2.7 billion, and that was against $18.5 billion of profitability.

Today we believe that roughly $13 billion of the industry's profits are coming from commercial real estate and highly leveraged transaction loans compared to the $27 billion of total industry pretax profits, or 50 percent of the industry's profitability is coming from these two activities.

So to your point, when they lose the ability even to write these loans, where are they going to replace the earnings, and, at the same time that they are under capital pressure to raise capital, who is going to give them the capital given the low returns from banking today. The return on equity of the industry today, even including the "profits" from commercial real estate and HLT lending is about 7.5 percent, and the cost of equity is 14 or 15 percent.

The CHAIRMAN. Now let me just stop you right there. Now you're referring to commercial banks here.

Mr. BRYAN. That's all I'm talking about.

The CHAIRMAN. Now it seems to me that what you have already said indicates that we are seeing something of an equivalent profile, different case facts than the S&L problem through the 1980's, but a profile that in other ways bears some real similarities to the S&L problem, and that is that as the opportunities for profitability and from traditional, long-standing sources began to dry up and reduce themselves, the S&L's began to reach for other higher risk activities. And with the lid off interest rates, they could bid up in a sense the rate of interest they would pay for deposits to attract money, to then turn around and invest in these higher risk activities.

That is what the S&L industry did during the 1980's, and it eventually blew out, and we had a State powers problems that added to it and some other things.

What I'm hearing you saying is that we have some of the same characteristics now embedded in the commercial banking system, and that if we look at what has happened over the last decade, these forces may be driving the commercial banking system into a position of exposure and risk that is way off the norm and much more equivalent to what we saw building up in the savings and loan industry.

Mr. BRYAN. I think we have a systemic problem that we have to fix.

The CHAIRMAN. Well, having said that, am I right in concluding that we are seeing some profile here that bears some real similarity to the buildup in the S&L situation?

Mr. BRYAN. The big difference is there is substantial capital, little fraud; there is basically good will and well motivated people in banks who are primarily following the law and, by the way, a regulatory process that is trying very hard to contain these forces.

The CHAIRMAN. Well, I hear that.

Mr. BRYAN. So there is a difference I believe, but the systemic problem of loss of profitability of the franchise is real.

The CHAIRMAN. Well, I heard Mr. Barth say a minute ago, as you did, that the fraud and the abuse that came in made the problem worse, but that what really drove the problem into the critical state were the earlier fundamental problems of the kind that you are describing. So that the fraud came in on top and made the problem worse, and it sounds to me like what you're saying between the two of you is that the nature of the business charter may change sufficiently and push banks out into a higher risk set of activities where we may be setting ourselves up or we may be in the midst of a situation that carries with it a brand new set of risks that we haven't maybe fully taken account of yet.

Mr. BRYAN. I think that is the issue, and there is one other aspect of it. We have to move very effectively because our economy is also at risk, because commercial banks have a broader impact upon the economy, particular, banks are far more important lenders to small businesses, mid-sized companies, and individuals than the savings and loan industry because of the relative size of the banking industry and its developed history. And if we let these institutions go the way of the S&L's, then we have a second effect of having significant economic issues as well as worrying about the solvency of the deposit insurance fund.

The CHAIRMAN. What is this credit crunch that we are seeing now mean? I'm getting calls all the time. My colleagues are coming to me with anecdotal information about a very substantial and rapid drying up of credit coming from banks to small business to commercial borrowers and so forth.

In your experience, is that accurate, and what does that mean in the dynamics of this problem at this time?

Mr. BRYAN. Well, I think it is a very serious issue. Obviously the worst case of all would be a credit crunch induced recession, which would lead to the recession that will lead to the charge-offs.

Senator DIXON. I might observe, if I may interrupt.

The CHAIRMAN. Please.

Senator DIXON. May I say to the Chair that this Senator met this morning with the home builders industry from his State with other members of the Illinois delegation. They gave us a very substantial pamphlet that I have given to my aides suggesting that that is exactly what is transpiring right now, that there is a regulatory credit crunch on that is leading their industry into a deep recession. How do you respond to that?

Mr. BRYAN. Well, I think there are issues of that. Our problem is, because of the deposit insurance anomaly, we basically built in the 1980's the real estate infrastructure we needed for the first 5 years of the 1990's, and that is an economic problem. We have basically built a lot of buildings that we cannot occupy, and that is an economic problem. There was a false economic boom created in the 1980's to which there will be some economic costs to unwinding, but that also has economic issues.

So, yes, some builders are being deprived of credit, but it's hard to say that they should be extended more credit to build when we already have more capacity in many classes or real estate than we need. I mean we have a problem that is going to create some pain.

The CHAIRMAN. Senator Garn.

Senator GARN. Let's go beyond loans for new construction. What the Senator is talking about, I continue to hear all the time. I had a specific example yesterday, a commercial office building built by two doctors who occupy it for their practice. Six years ago they built it. The loan on it is only 30 percent of the current market value, and therefore it has a 70 percent equity. They have never missed a payment at any time. Their practices are not going to go down, they are very successful practices, and the bank says next year in 1991 they are not going to renew their loan.

Now what sense does that make to have that kind of overreaction, where you've got a loan that is paying, and even if it did not, you've got a 70 percent equity in a building, and that's a different story than saying should they loan more if there is excess capacity. Now that is happening day after day after day.

Mr. BRYAN. It is also happening in small business credit, too. The problem with commercial real estate is greater the more you have market pressure and regulatory pressure, and right now the marketplace is saying that any commercial real estate on your balance sheet is bad. So you lose more stock price than the earnings from it. Regulators are saying you need more capital, and we are going to examine those loans more tightly than other things. The issue is: what are you going to do as a bank given these conflicting pressures? You are probably not going to make as many new loans as you would have otherwise. We are on the horns of a dilemma. I think we are seeing the cost——

Senator GARN. You're missing my point, not making new loans, but why call good loans that have absolute good performance and good earnings?

Mr. BRYAN. The reason why you call good loans is because you are under very strong pressure to get your commercial real estate loans down. It doesn't matter whether they are made of gold or not.

The CHAIRMAN. And aren't you more like, if you will yield——

Mr. BRYAN. I'm not defending it.

The CHAIRMAN. You're not defending it. You're explaining it.

Mr. BRYAN. I just said that we have a confluence of regulatory and market forces, and bankers trying to do what they can in that bind.

The CHAIRMAN. And isn't another perverse incentive here that the loan they are likely to call is the good loan because they can get the money back. They are not going to call the bad loan, but they are going to call in the good loan.

Mr. BRYAN. That is a problem.

The CHAIRMAN. So, you have the most perverse twist on this whole thing, and that is that the credit out there that is a decent credit is the guy that basically gets hit between the eyes in all likelihood I mean, when you've got this pressure.

Mr. BRYAN. I think we have got ourselves in a real muddle, yes.

Senator DIXON. A very sage observation.

Senator GARN. It doesn't make sense to call good loans. Now people are not thinking very correctly if in the panic over regulators being tight and bad loans that they call the good ones. No matter how hard you try to explain it, and I understand what you're saying, it still doesn't make any sense. If I were a banker, and I had good loans that I had no doubt that they were going to continue to pay and had good earnings from those loans, it seems to me, unless I am awfully naive, I would try to get rid of my bad loans and keep my good ones.

Mr. **Bryan**. I hope the situation you describe is an anomaly. I do not know how widespread the situation is. Most banks I know want more high-quality assets still. There are some asset categories about which they have gotten so much criticism about that they are probably looking to do anything they can, and I'm not trying to defend anyone. I'm just saying that I am as an observer struck by the confluence of very conflicting forces.

Senator **Garn**. Well, it is anecdotal, but nevertheless it is widespread when you get people coming up to you that you don't know. They know me because I'm on the Banking Committee—every place you go, and I would assume that's true of my colleagues, we are hearing it too widespread to just be occasional. Somebody feels they are being mistreated. It's even volunteered in airports, when people ask what are you going to do about this.

Mr. **Bryan**. I think there is no doubt that there is a silent credit crunch going on in some asset categories in some parts of the nation.

The **Chairman**. I might just say, too, Senator Garn, that we are all getting this anecdotal information. I have been hearing cases, too, of instances where loans are outstanding to individuals who have very substantial balance sheets, I mean very financially solid borrowers, and they have got slow projects right now because of the nature of the slowdown in different parts of the country. So these individual borrowers are making the payments. They are staying current on their payments by paying the payments out of their own personal resources and are being told nevertheless that they can't do that, that the loan is still going to be classified as non-performing even though they are making the monthly payment because that in this environment is seen as something that has to go into the other category.

You should know, and the press and others here should know that we are scheduling right now a hearing in this committee on this question with the chief regulators, and we are going to be asking Alan Greenspan, Clark, and Seidman to come in here and sit where you are and share with us some of whatever it was they said to the banking industry a couple of weeks ago, and intend to examine this fully in the light of day.

Mr. **Bryan**. I think it's a very narrow tightrope that they are walking between getting the right balance between regulating and not regulating at all. The worse kind of calamity would be to overregulate credit extension to economic activities at this time. That would not be helpful to anybody.

The **Chairman**. Well, I want to just take one more minute, and I apologize for the interjections, but I think it's important. If you go back to your previous chart [exhibit 5] if you still have it there, the one with the buildup of the losses in the commercial banking system.

What you are telling us from the vantage point of what the historical relationships have been is that if we were to have a recession kick in here, we could see that blue zone that is now out into the late 1980's and 1990's literally double. Is that right?

Mr. BRYAN. Go off of my chart, yes.

The CHAIRMAN. And because of the fact that we are now in a position, and I would describe that as a unique vulnerability. We have not had that condition at least going back in modern history. So we are now positioned in such a way that if we got hit with a recession, and if the historic relations hold, and you think they would, we would see a doubling of bank write-offs here and that the amount would be in all likelihood more than the insurance system itself could contain in terms of its present balances.

Mr. BRYAN. That is a very real vulnerability, yes. I mean I actually used a variation of this chart 2 years ago when I wrote a book. The problem is that we now have 2 more years of history and losses have actually gone up. So the vulnerability is greater. I mean I do not know what 1990 will bring, but the first quarter's results would indicate that we are going to have a lot of charge-offs this year.

The CHAIRMAN. Well, the reason we are raising this is not to create a lot of unfounded fear and anxiety, but to try to understand where we are. I mean it's much better if we have a realistic appraisal of exactly what is going on so that we have some opportunity to think about what the policy adjustments might be so that we don't get into even a worse situation.

Senator Dixon, you wanted to make a comment.

Senator DIXON. Well, I only wanted to say respectfully, Mr. Chairman, that I hope soon we can hear my friend from Chicago, Mr. Kaufman, because at some point after they have all testified, and I hear the problem and I suspect the three of us know the problem. What I'm anxious to determine is whether the three of these find gentleman can between them suggest some kind of a solution that appeals to us.

Mr. BRYAN. Let me try to get to those slides right now if we could. [exhibit 8.]

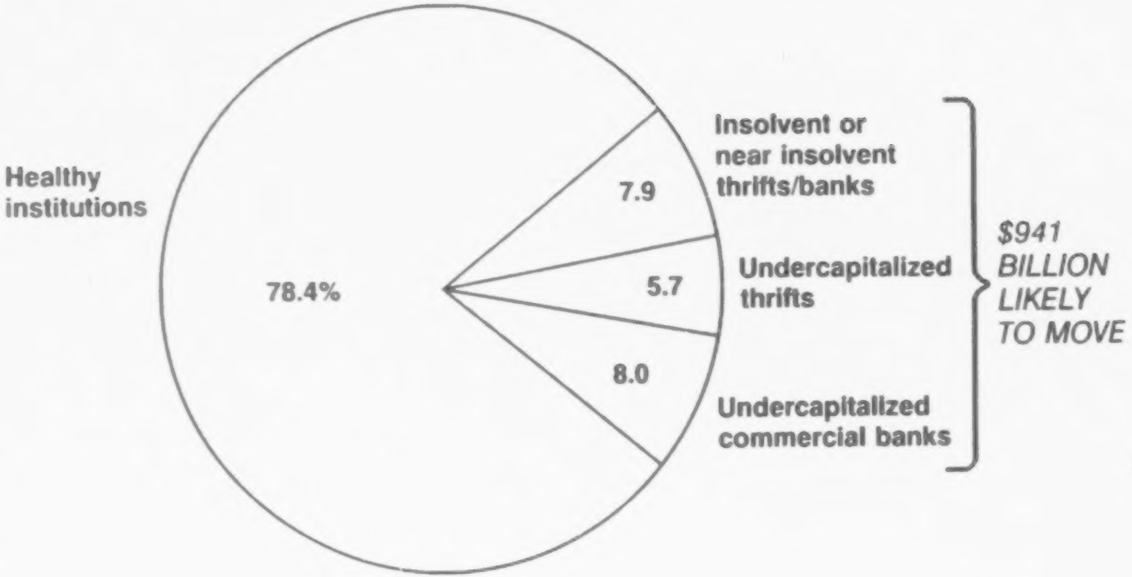
Just one last slide on the problem. Right now we have $940 billion of deposits in institutions which are undercapitalized relative to regulatory rules out of a $4.3 trillion total, which is a very large number and is growing. Every time we do the chart the slice of the pie that is represented by these institutions is growing.

All this is to build the case that we really do need to do something fundamental as soon as we can. [exhibit 9.]

Exhibit 8

1990
$4 Trillion liabilities, insured depositories

100% = $4.3 trillion



Source: FDIC Reports of Condition and Income; McKinsey analysis and estimates

McKinsey&Company, Inc

Exhibit 9

"MUDDLE THROUGH"

- Resist economic forces
  - Protect small players
  - Protect independent thrift industry
  - Not repeal Glass-Steagall
  - Not repeal McFadden
- Fail to eliminate marginal capacity
  - Continue to destroy franchise value
  - Not quickly resolve cases
  - Not deal efficiently with problem real estate
- Interfere with credit flows
  - Overregulate banks
  - Over capitalize
  - Over raise deposit insurance premiums

- Raise cost of deposit insurance debacle to stretch nation's financial capacity
- Destruction of competitiveness of banking industry
- Stagnating economy beyond impact of fiscal and monetary policy
- Loss of competitiveness of U.S. as a nation

Mr. **Bryan**. I believe that we run the risk of trying to "muddle through," by muddle through I meant resisting economic forces, protecting small players just because they are small, and protecting an independent thrift industry, not repealing Glass-Steagall and not repealing the McFadden Act. There are real economic forces that are at work that we need to accommodate with change in law.

Second, failure to eliminate margins of capacity. Our problem is we have kept a lot of inefficient competitors in the game and they need to be taken out of the system to restore the franchise value to the players that are effective.

And, finally, if we interfere with capital flows, which is what we have just been talking about, if we overregulate banks, if we overcapitalize them, if we over-raise deposit insurance premiums, we will wind up raising the cost of the final bill for our deposit insurance system. Moreover, we will destroy the competitiveness of our banking industry. Finally, I believe our economy will stagnate and we will hult and lose the competitiveness of the United States as a nation. [exhibit 10.]

What I hope, instead, is that we can fundamentally reform regulation to make it accommodate market forces and not work against them or in a destructive combination with them. What we need is deposit insurance reform, bank holding company reform, national interstate banking reform, and effective functional regulation. [exhibit 11.]

The model I am proposing is a core bank model. There are some natural assets and liabilities that belong in a bank that are valuable in an economic sense. They have to do with the payment system, insured savings accounts, and insured core deposits. Core banking also includes assets, loans to individuals, loans to small businesses, loans to mid-size companies, and related activities such as the trust business.

No one has gotten in trouble yet that I know of making those kinds of loans, and frankly the banks are the most economic deliverer of those services. That is because these classes of assets are very difficult to securitize and, in fact, they are more expensive to structure for securiziation than the value of doing so, and therefore they ought to stay on a bank's balance sheet. [exhibit 12.]

Exhibit 10

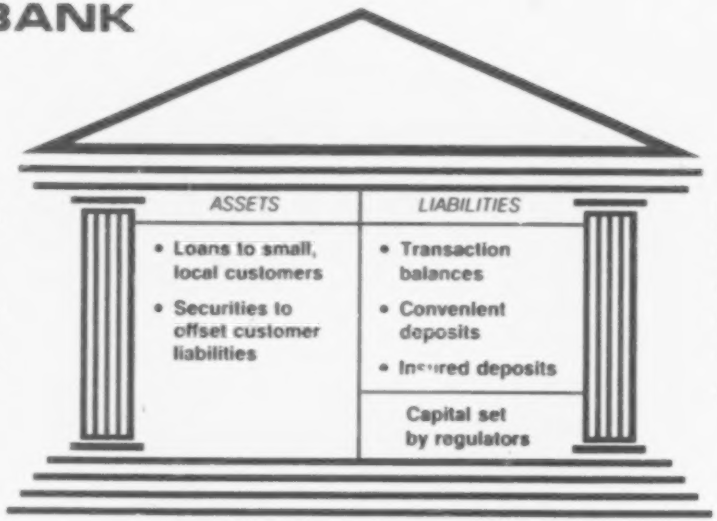
"REGULATORY REFORM"

- Deposit insurance reform
- National banking reform
- Holding company reform
- Effective functional regulation

- Minimize costs of deposit insurance debacle
- Creation of world class banking system
- Financial economy as a source of strength to real economy

Exhibit 11

CORE BANK



NATURAL CUSTOMERS

- Individuals
- Small businesses
- Mid-sized companies

ASSETS

- Loans to small, local customers
- Securities to offset customer liabilities

LIABILITIES

- Transaction balances
- Convenient deposits
- Insured deposits

Capital set by regulators

COSTS

- Branches/ATMs
- Payments system
- Custody
- Deposit insurance
- Reserves

- High risk loans?
- Securities above those needed to offset customer liabilities?

- Price-sensitive liabilities?

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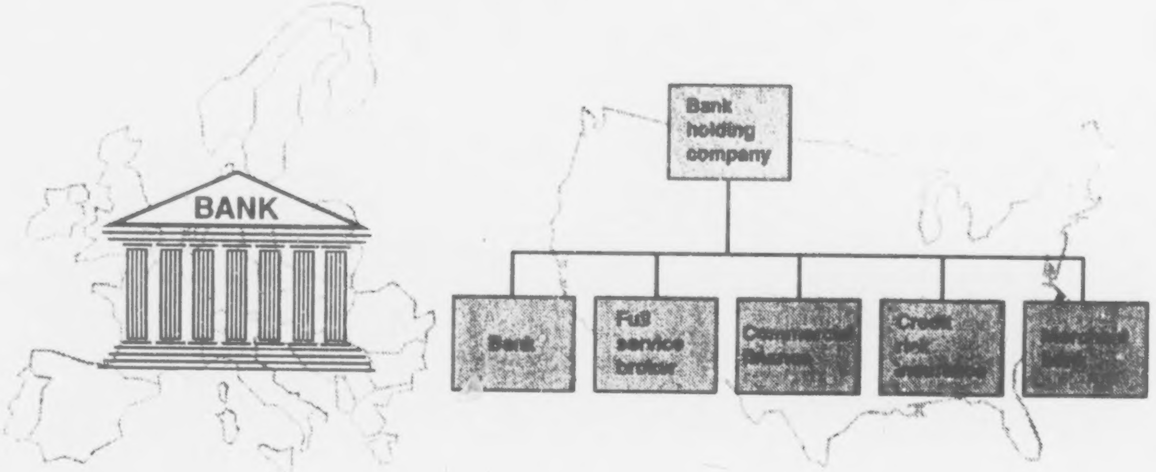
Exhibit 12

"UNIVERSAL" BANK VS. BANK HOLDING COMPANY


BANK
Bank holding company
Bank
Full service broker
Commercial
Credit

McKinsey & Company, Inc.

Mr. **Bryan**. There has been some discussion of which model do we go to, a universal bank model or a bank holding company model. I think that there is a big problem with the universal banking model, which prevails in Europe. You have to have a cartel in operation to make it work. That is the source of the profits that keep those universal banks profitable, and I do not believe we are not going to go back to a cartel.

The bank holding company model I think is flawed because it is an artificial barrier. [exhibit 13.]

There are some variations. You could, for example, regulate a bank and then put subsidiaries under the bank. This is probably the way the Japanese are headed, or you could do a core bank as part of a financial holding company, and you then use firewalls and, by the way, when I talk about firewalls I'm talking about really regulating intercompany transactions. I'm not talking about all the noncompetitive other firewalls. I'm just basically saying keeping people from moving assets around in a crisis. [exhibit 14.]

And, by the way, if you used this holding company model and had the core bank regulated by the FDIC, you would migrate out non-qualifying, highly-leveraged transactions and non-qualifying commercial real estate loans. This doesn't mean the good loans couldn't stay in the core bank. You could just basically say that you can finalize commercial real estate if the building is leased up sufficiently, to provide something like 150 percent coverage of principal and the interest payments from the cash flows of the property. But if the loan doesn't meet those tough standards, then you ought not to do it in the core bank but rather in a commercial finance subsidiary where you don't have the Federal safety net involved. [exhibit 15.]

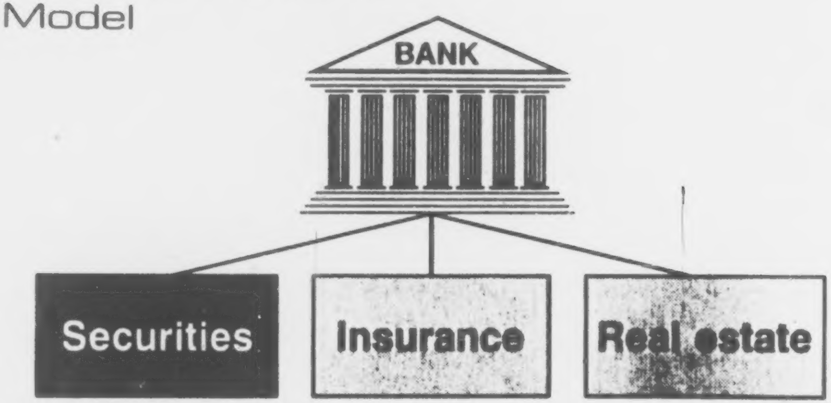
I also think we should separate wholesale money market activities from core banking. By doing so you get rid of the too-big-to-fail problem and you put the money market activities in a separate activity. The core bank basically would have deposit insurance, it would have historical value accounting if assets are held to maturity because it's not worthwhile to structure the assets for making them marketable, it would have a Federal Reserve liquidity line, and it would have the lending standards determined by regulators with a bias toward conservatism.

In the wholesale money market you would have no deposit insurance because wholesale activities do not have enough margin to be able to pay for the insurance. You would have marked to market accounting, and you would basically use this model for both investment banks and for commercial bank subs engaged in the same activities. You would have a liquidity line. It is not an insurance line because what happens at the Federal Reserve, if it had to provide the liquidity line it would take preemptive collateral and then liquidate the assets out of the capital of the institution, which is the way you take down a securities firm. You can do that because the assets are marked-to-market, and the market determines lending and capital standards. [exhibit 16.]

Exhibit 13

UNIVERSAL BANK:

U.S. Model


BANK
Securities
Insurance
Real estate

- Royal Bank of Canada
- Canadian Imperial Bank
- Barclays Bank

→ Section 20
Securities Activities

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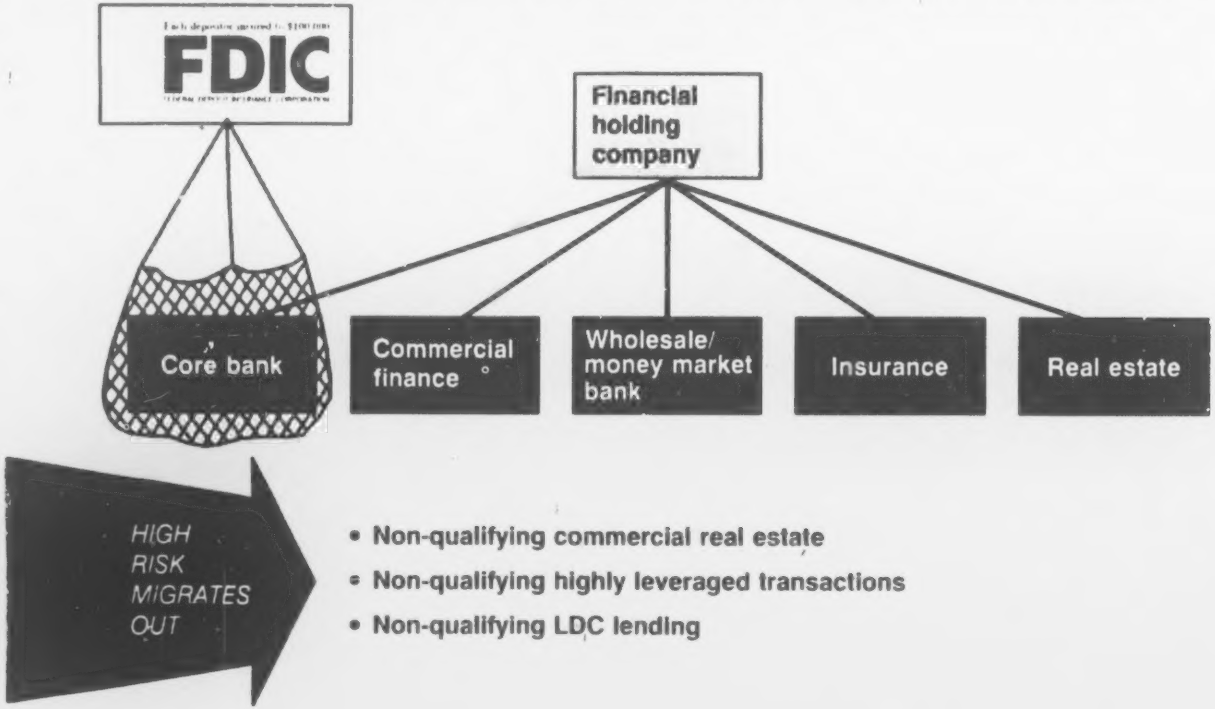
Exhibit 14

FINANCIAL HOLDING COMPANY MODEL



Each depositor insured to $100,000

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION

Financial holding company

Core bank

Commercial finance

Wholesale/ money market bank

Insurance

Real estate

HIGH RISK MIGRATES OUT

- Non-qualifying commercial real estate
- Non-qualifying highly leveraged transactions
- Non-qualifying LDC lending

McKinsey & Company, Inc.

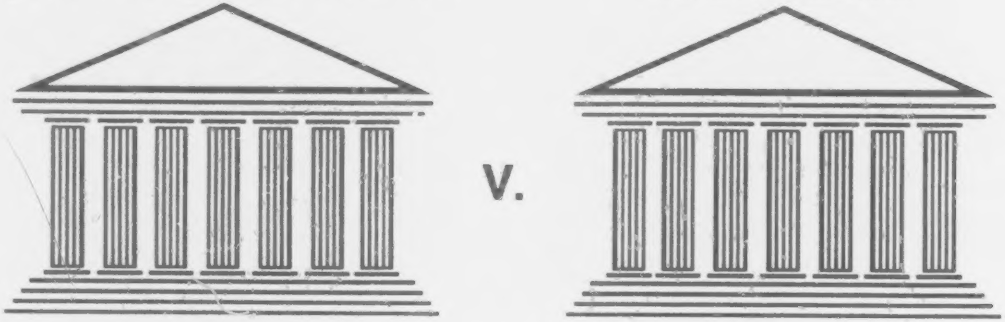
Exhibit 15

ALTERNATIVE SEGREGATED BANK MODELS

CONCEPTUAL

WHOLESALE/MONEY MARKET BANK

CORE RETAIL BANK



WHOLESALE/MONEY MARKET BANK

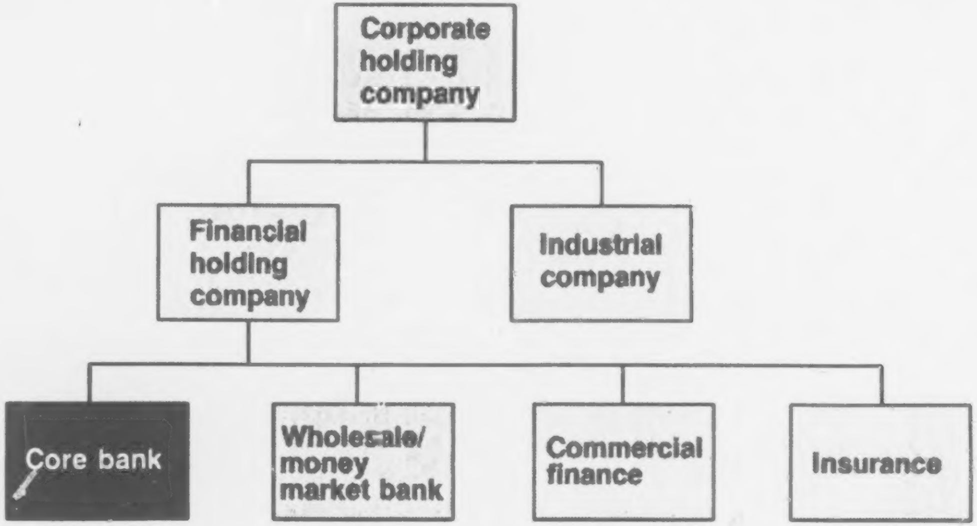
- No deposit insurance
- Marked-to-market accounting (Limit on non marked-to-market assets to capital)
- Federal Reserve liquidity line
- Market determines lending standards, subject to capital

CORE RETAIL BANK

- Deposit insurance
- Historical value accounting (If assets held to maturity)
- Federal Reserve liquidity line
- Lending standards and capital determined by regulators

Exhibit 16

FUTURE HOLDING COMPANY MODEL?


Corporate holding company
Financial holding company
Industrial company
Core bank
Wholesale/ money market bank
Commercial finance
Insurance

McKinsey & Company, Inc.

Mr. **Bryan**. Then there is the issue of whether or not you want to have a Bank Holding Company Act any more or not. I believe that we may have to look at non-banks providing the capital to recapitalize some of the industry. I don't see where all of it is going to come from within the banking industry.

If you keep the core banks separate, then the historical reasons to keep commerce separated from banks begins to change.

That concludes my remarks.

The **Chairman**. Thank you very much.

[The complete prepared statement of Lowell L. Bryan follows:]

TESTIMONY TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Deposit Insurance and Regulatory Reform

Lowell L. Bryan

May 22, 1990

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DEPOSIT INSURANCE AND REGULATORY REFORM

SUMMARY

By Lowell L. Bryan

My operating premise is that the U.S. financial system needs a fundamental overhaul - of necessity beyond just deposit insurance reform - to serve as a source of strength for our domestic economy and assure our financial institutions a competitive place in the global economy. We are at a critical juncture in our Nation's financial history. We can either continue to "muddle through" by resisting basic economic forces, permitting uneconomic risk-taking, failing to eliminate marginal capacity, and interfering with credit flows, or we can embark on a path of significant reform in the 1990s.

Specifically, we must restore and protect the franchise value of our depository institutions, which in turn will protect and strengthen our deposit insurance system. In a world where we have a market anomaly known as deposit insurance, the government has a direct interest in ensuring that the basic banking unit - which I define later as a "core bank" - operates safely and efficiently efficiently and is profitable. To ensure the necessary margins for banks to remain healthy and competitive, several action-steps are required:

¶ Early resolution of failing and insolvent financial institutions

¶ Use of better accounting, including market value accounting where feasible

¶ Elimination of the use of brokered deposits to fund basic banking activities

¶ Removal of laws and regulations that have no economic value

¶ Prevention of uneconomic risk-taking through the restructuring of the financial services industry.

In my view "deposit insurance reform" is only part of the solution. We need to address the more fundamental problem of a government that has been absorbing risk that should be borne by the-marketplace. We all know by now that there are limits to how much of this risk the government is willing and able to pay.

Moreover, our current overall regulatory structure works at cross-purposes with certain fundamental, economic forces. If we continue to jerry-rig the financial system to protect it from those fundamental economic forces, that jerry-rigged system will soon collapse under its own weight. There is a better way, and I am here today to argue for it.

Because we need to restore the franchise value of our banking industry, I believe that we should stop concentrating on fine-tuning a system that is flawed and start concentrating on the design of a smarter system for the future that will work and keep banks profitable.

My thinking has progressed since I wrote the book, Breaking Up the Bank, in which I proposed a risk-free banking model. I have moved away from that, to a model that includes a segregated, "core" bank within the holding company.

In this revised model, the core bank is a segregated, regulated, FDIC-insured bank that would have some significant limits on how it operates in the future. The reasonable quid pro quo, however, would be that the holding company would have expanded freedom to engage in new financial activities outside that core bank. That is, the financial holding company could include both a core bank and a separate securities subsidiary, which would be a wholesale/money market/investment bank. In this bank, non-qualifying assets of the core bank (e.g., commercial real estate, highly leveraged transactions, etc.) would be funded from the market place, rather than from FDIC-insured deposits, in a corporate finance affiliate. Market discipline rather than regulation would keep this wholesale bank whole - or else investors would lose their money, not the FDIC. To prevent financial panics, this wholesale bank would have a Federal liquidity line.

First, the core bank. The natural customers of the core bank are individuals, small businesses, and mid-sized companies. Its core business is to lend to these customers, and to provide these customers with convenient and insured deposits and transaction balances. We need this kind of bank because it adds economic value to this customer set, because we need to protect the payment system, and because I believe there is a social contract that deposits from individuals should be made safe by the government. This social contract is the reason and justification for the anomaly in the marketplace called deposit insurance. The government has the mission of keeping the FDIC-insured bank economic and protecting it, and that means restricting market forces in that one enterprise to maintain its continued franchise value.

To carry out that mission, we have to change some things. Probably most important, we have to take brokered deposits out of this system and remove the barriers to consolidation that are preserving overcapacity.

The wholesale/money market bank would serve corporations, institutions, and governments, with a broad variety of commercial banking and investment banking products. This bank would operate in both the money and securities markets, buying, selling, underwriting and distributing both debt and equity securities. That is, this model would eliminate the now obsolete distinctions created by Glass-Steagall and create one kind of wholesale financial institution, with one body of regulation. I personally have no opinion about which body should regulate it, as long as the regulation is coherent and functional. Further, that regulation should only extend to rules that help the market forces work.

Of course, this model raises issues not only about who should regulate each entity, but also who might own each entity. I would recommend a model in which a financial holding company, which could include a core bank and a wholesale bank, might in turn be held by a holding company which had no restrictions on which other subsidiaries it might own. I realize that there are historical arguments against this approach, but if new capital does not come from non-traditional sources (i.e., commercial enterprises), then where are we going to get additional capital to recapitalize the industry?

This approach would reintroduce market discipline to limit unwise risk taking. Risk taking that did not qualify for FDIC-insured depositories would have to be financed through funds provided by investors to subsidiaries of the financial holding company. Investors would, of course, demand higher rates for their uninsured investments - but market prices for financing higher risk activities would also rise, since uneconomic risk-taking by "dumb" insured depositories would no longer be available to finance such risks. Only financial holding companies which had the capital and the skills to persuade financial and capital markets that they could underwrite such risks would be able to raise funds without federal deposit insurance. Margins would depend on the ability of the institution to add value to each customer.

Moving from industry regulation to functional regulation, which is what I am describing, will not be easy. But I think expending the effort now will eliminate a huge number of problems as we move forward and financial services continue to evolve. Functional regulation, where everyone in a business follows the same rules, will allow the industry to evolve with economic forces, rather than against them.

SENATE BANKING COMMITTEE TESTIMONY DRAFT

May 22, 1990

Mr. Chairman and Members of the Committee, I welcome this opportunity to testify on deposit insurance reform. You are to be commended for initiating these hearings and starting the educational process that will set the stage for the Administration's report to Congress in 1991, and, hopefully, significant regulatory reform.

Although my testimony is based upon research undertaken by my Firm, McKinsey & Company, the opinions expressed are my own and do not necessarily represent the views of my colleagues or clients. As you know, McKinsey & Company is an international consulting Firm that serves top management in 23 countries on strategic and operational issues, but we do not lobby on behalf of our clients.

My operating premise is that the U.S. financial system needs a fundamental overhaul - of necessity beyond just deposit insurance reform - to serve as a source of strength for our domestic economy and assure our financial institutions a competitive place in the global economy. We are at a critical juncture in our Nation's financial history. We can either continue to "muddle through" by resisting basic economic forces, permitting uneconomic risk-taking, failing to eliminate marginal capacity, and interfering with credit flows, or we can embark on a path of significant reform in the 1990s.

Simply to muddle through means that we will stretch this country's financial capacity (raising the cost of the deposit insurance debacle), destroy the competitiveness of the banking industry and, consequently, experience the loss of competitiveness as a nation. Choosing the course that I favor, however, can put us on a path where the financial economy can act as a source of strength for the real economy and we can create a world class banking system.

Specifically, we must restore and protect the franchise value of our depository institutions, which in turn will protect and strengthen our deposit insurance system. In a world where we have a market anomaly known as deposit insurance, the government has a direct interest in ensuring that the basic banking unit - which I define later as a "core bank" - operates safely and efficiently and is profitable. To ensure the necessary margins for banks to remain healthy and competitive, several action-steps are required:

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In my view "deposit insurance reform" is only part of the solution. We need to address the more fundamental problem of a government that has been absorbing risk that should be borne by the marketplace. We all know by now that there are limits to how much of this risk the government is willing and able to pay.

Moreover, our current overall regulatory structure works at cross-purposes with certain fundamental, economic forces. If we continue to jerry-rig the financial system to protect it from those fundamental economic forces, that jerry-rigged system will soon collapse under its own weight. There is a better way, and I am here today to argue for it. I will make, and explain, three points today.

- First, over the past two decades, our banking laws and regulations have worked against fundamental economic forces, thereby weakening the institutions and the nation they are meant to strengthen.

- Second, we have the choice now of accepting the consequences of such "muddling through" - or choosing instead to design a new system that takes advantage of the inevitable forces that are acting on our financial economy.

- Third, this leaner, smarter system would include elements of deposit insurance reform to be sure, but would depend as well on the adoption of a new model for the redesign of the banking industry, which I will describe in broad outline.

THE PAST: WORKING AGAINST FUNDAMENTAL FORCES

Mr. Chairman, I had the honor to address this group for the first time in October of 1987. At that time, I described the weaknesses in our credit system, as I saw them, and suggested that the major reason for these weaknesses was incomplete regulatory reform.. My view was, and is, that we introduced intense competition into our financial system without changing the regulatory framework enough to cope with the natural results of competition - the fact that some players lose. Because regulation prevented weak institutions from leaving the industry - and indeed encouraged them to take more and more risk to stay in the game - we created lending overcapacity which, all too often, chased bad credits. The results were inevitable, and we are all familiar with the current estimates of the probable costs of cleaning up the mess.

In January of 1989 I came back to this forum, to urge this Committee to act promptly to resolve the thrift crisis and contain the damage by imposing stricter lending standards and setting tighter capital requirements for all lending institutions. I have been very happy to see that some action has been taken - the FIRRE Act, the enhanced enforcement action of regulators, and this very inquiry is evidence that the United States government understands that we have a serious problem here and that the time to address that problem is now.

We have had plenty of evidence that depository institutions do not become more competitive, in my terms, if they take on uneconomic credit risk. I think an industry is "competitive" if it is comprised of institutions that can add value to their customers - as demonstrated by their profitability, which gives them the capital base they need to be able to absorb credit risk and serve customers. Institution after institution has been destroyed, and it has not been because they were too constrained in their ability to lend money. On the contrary; it has been because they were incented sometimes explicitly, to lend too much, to the wrong people.

How did we make our institutions less competitive, when we were trying to help them become more so? By maintaining laws and regulation - such as the Glass-Steagall Act or the McFadden Act - long after they had been made obsolete by economic forces that were shaping the industry. As Federal Reserve Board Chairman Alan Greenspan recently observed in Congressional testimony: "Social and regulatory policies are not free, no matter how desirable they may be perceived to be."

Banks Shaken by Outside Competition

Up until the early 1980s, the banking industry consisted of a series of comfortable, profitable oligopolies. In every region, banks conducted their business so as to earn a comfortable net interest margin - that is, a comfortable spread between aggregated interest income and aggregated interest expense. Banks' costs were shared across products, and each bank's capital strength was shared, with one pool of capital to absorb all risk. As long as their net interest margin was big enough, bankers did not care whether their interest income came from savers or borrowers, or whether income from profitable products was subsidizing the costs of weak ones. Indeed, until recently few bankers even thought about product economics - except insofar as they priced products wherever they needed to achieve the net interest margin they needed. Pricing practices are oligopolistic; I remember the days when there was a Boston price for everything - and when, for example, consumer loan rates on the West were 15 percent or more while in the Northeast they were in the 8 percent range. Each local market got whatever net interest margin its own players needed to cover all their costs.

Even as late as 1980, the margins were coming from very high quality business. During that year, roughly 68 percent of the industry's income came from core deposits. Only about 5 percent came from commercial real estate loans. All other income (which includes all other loans) came to about 28 percent.

But then things started to change the industry. New technology, economic volatility, and globalization all had an impact, but the most-direct force for change came from new, non-bank competition. Economic forces behind money market funds started luring away consumer deposits, just as economic forces driving commercial paper attracted many of the best corporate borrowers away from banks.

In turn, the industry competed back. In 1982, the commercial bank and thrift industries actually got together for once and helped pass the Garn-St Germain Act, which accelerated the removal of the regulatory ceiling on the rates they could pay for deposits. Immediately money market demand accounts began to compete for those fleeing deposits, and for a time they halted the growth of money market funds. Many institutions sought brokered deposits, which were particularly dangerous. Nearly any institution could attract them, based on an irresistible sales pitch that offered high rates, liquidity, and government insurance.

Here is where many of our problems began. Money then flowed out as loans, many made by institutions - particularly thrifts - with little capital and fewer lending skills. Much of it went into commercial real estate, junk bonds, and condominium loans. Some of these institutions did not realize that they were taking imprudent levels of risk - and what was worse, these weak institutions dragged the good institutions down with them. Even the skilled banks, who recognized risk and wanted to avoid it, were forced to lower their standards because the competition extended not just to price but to terms and credit availability as well.

If the skilled banks did not cave in against their better judgment on terms and availability, they lost the business. So the skilled banks got whipsawed time and time again, and we saw incredibly generous terms and conditions during the 1980s. For example, in commercial real estate lending we saw: (1) high loans-to-appraised value (up to 100 percent for some institutions); (2) much less reliance on personal guarantees; (3) fewer pre-leasing requirements and shorter lease periods; (4) interest carry 2 to 3 years beyond the time the building was completed; (5) no requirement for permanent refinancing; and 6) an expanded list of acceptable borrowers.

Unstoppable Forces set in Motion

Gradually during the 1980s, as banks, thrifts, and non-banks fought this new kind of battle, four strong economic forces emerged in the financial services industry: consolidation, securitization, technology, and disaggregation. All of these forces - if they were allowed to work unhampered by uneconomic laws and regulations - would make financial services more "competitive" in my terms.

First, consolidation. In a competitive environment, it is natural for stronger players to defeat, and absorb, weaker ones - particularly if the weak institutions playing a risky game like the one I have just described. Now, when I say "stronger" I certainly do not mean necessarily "bigger," because as I will show later there are many smaller community banks that are very well positioned to do a lot of good, profitable business going forward, provided that they are not overly hampered by regulation. But strong banks should absorb weak banks. Despite the fact that regulation has prevented this natural outcome from taking place most of the time - including across artificial geographic boundaries because of the McFadden Act's uneconomic restrictions on interstate branch banking - consolidation is indeed underway. Between 1980 and 1989, the share of the industry held by medium and large regionals commercial banks almost doubled, from 25 percent to 46 percent of the industry.

Consolidation is taking place for many reasons: First, there are a great many failing institutions, and someone has to take them over. Second, relatively few players can raise the capital to make acquisitions under the new risk-based capital guidelines. Third, interstate banking barriers, which have slowed natural consolidation in the past, are falling. Fourth, banking is being changed by new technology and information systems, which have a large scale effect. Today, for example, the 35 largest bank holding companies account for roughly 65 percent of the industry's systems expense, and that percentage has been going up each year. A final reason for consolidation is that banks have highly differentiated skills, particularly in retailing. Some players are getting very good at what they do, and they are winning.

The second force is securitization. For many classes of assets, structured, securitized credit is a more efficient form of financing. Since it was conceived in the 1970s as part of the government-backed mortgage pass-through program, credit securitization has extended to privately-issued residential mortgages, commercial mortgages, automobile loans, credit card receivables, and even some commercial loans and lease receivables. Since 1986, roughly $383 billion in mortgage outstandings, and roughly $70 billion in other types of credit, have been securitized.

As you are all aware, securitized credit is delivered through a system quite different from the traditional bank lending system (Exhibit 1). In the securitized system, different players can be responsible for originating the loan, structuring the deal, providing sufficient credit guarantees to make the issued securities salable, placing the securities, trading the securities, and servicing the debt. Because current regulations generally prohibit our banks and thrifts from participating in many of these activities, the securitized credit industry has sapped business away from the banking industry.

With depository institutions under pressure to earn better returns on the deposit side, we have seen a widening spread between money market deposit accounts and money market mutual funds. As a result, the growth of money market mutual funds has resumed, and we have also seen continued growth in commercial paper, mortgage-backed securities, credit card receivables, etc. And there is a lack of sufficient spread, on the margin, between the cost of purchased funds and the yield on high quality assets to justify capital costs in terms of a bank's balance sheet. Thus, all signs point to the fact that the economic force and securitization will continue at a rapid pace.

Technological change is probably the single most powerful environmental force driving regulatory change since it also drives changes in markets and competitive behavior. In the long run, therefore, technological change may be the most powerful force affecting financial institutions since it is technological change which continually makes existing regulation and law obsolete.

It is hard to overstate the importance of technological change in the financial services industry. On the one hand, the second and third order consequences of technologies introduced in the late 1970s and early 1980s continue to unfold. For example, the further globalization of financial markets driven by changes in both "hard" technology (i.e., telecommunications, information distribution, data processing) and "soft" technology (i.e., financial innovation such as interest rate swaps, currency swaps, etc.) still continues. Similarly, the technology of credit securitization has only just begun to have an impact in the United States and has yet to be introduced in most other countries. Going forward, a raft of new "hard" technologies (e.g., imaging, relational data bases, artificial intelligence, workstations, and network architecture, etc.) are only just now beginning to find practical applications.

The long term potential impact of these new technologies is enormous. For example, the vision of a nearly "paperless" bank is no longer just a futurist's dream. Over the next decade, most paper is going to disappear from financial institutions. The potential improvements from applying these technologies to improve revenues and to reduce costs through fundamentally redesigning the business system are absolutely enormous.

Finally, disaggregation of the business system of each of the basic underlying products is another fundamental change in financial industry structure. Historically, almost all participants in the financial services industry have been fully integrated suppliers. In many functions of the business system, however, many institutions have insufficient scale or skill to perform those functions as cost effectively as a highly-skilled outside firm. As long as cartel-based profits are high, this inefficiency can be cross-subsidized through excessive profits made elsewhere. But as competition intensifies and puts pressure on margins, financial institutions are finding that they can get better service, at less cost, by subcontracting functions where they are inefficient or ineffective - that is, to disaggregate and restructure through spin-offs, mergers, joint ventures, or shared production.

In turn, this restructuring converts a single, integrated complex business into several simpler, easier to manage businesses. For example, in the United States, the mortgage banking industry business system has disaggregated into sub-industries devoted to mortgage origination, mortgage credit insurance, mortgage placing and trading industry, and mortgage servicing (i.e., processing). Depending on the economics related to each sub-function, the relevant scale to succeed may be local, national, or even global. That is, mortgage origination is first and foremost a local or regional business, mortgage servicing is a national business and trading mortgage backed securities is a global business. In those business functions with national or global scale, this process of disaggregation can create very large enterprises which operate in just a single function of the business system. In other words, disaggregation creates more large players, not less.

Changes in Law and Regulation Work Against Economic Forces

The problem was that our regulations and laws did not allow these essentially healthy forces to work in the banking industry in a positive way. Instead, we used laws and regulation to protect various constituencies from the effects these forces would otherwise have. As a result, competitive energy was translated into uneconomic risk-taking. That risk-taking diverted resources into uneconomic activities, which ultimately required subsidies - which the government is paying now for in the thrift industry. Let's hope that the FDIC does not also prove to be in need to government funding. Let me explain how it happened.

In the early 1980s, we did indeed enable banks and thrifts to "compete" more fiercely, in some areas, against non-banks and each other, than ever before. But we failed to change regulation enough to deal rationally with the losers. With government insurance for all, institutions with weak management skills, poor asset/liability structures, excessive cost structures, and non-competitive strategies - which in a truly competitive environment would have gone out of business - were not allowed to lose. Instead, these weak players made more and more loans in riskier and riskier markets.

In commercial and industrial (C&I) lending, with commercial paper sapping the high quality borrowers, commercial banks advanced into highly leveraged transactions. They increased their C&I business by about 5 percent, compounded, since 1980 - but the percentage of total industry assets in C&I loans fell from 38.5 percent in 1980 to 30.5 percent in 1989. During the same time, commercial real estate grew at a compounded annual growth rate of 15 percent, rising from 10.5 percent to 18.1 percent of total industry assets.

Today, we estimate that roughly 12 percent of the commercial banking industry's net interest margin of about $112 billion comes from commercial real estate loans and highly leveraged transactions. To put that in perspective, in 1980 the industry earned pre-tax profits of $18.5 billion, with $2.7 billion of that from commercial real estate (there were very few highly leveraged transactions in those days). In 1989, pretax profits for the industry were $27.1 billion, with nearly half of that - $12.9 billion - from these two high risk asset classes. Going forward, depository institutions will have to replace these assets with other profitable, more stable ones (see Exhibit 2).

Between incomplete regulatory change, and laws that forced banks to pay a price for the "freedoms" they were given, a great deal of money was funneled into enterprises that, 10 years ago, banks would not have funded for very good reasons. Commercial real estate is one of the best examples. In fact, we may have destroyed our real estate industry by over-supporting it with financing at current terms and conditions.

There is an axiom that if you give a developer money he will build. That is what happened. In every year from 1980 to 1989, construction of offices exceeded growth in employment - and that oversupply touched off a pernicious cycle. Increasing vacancy rates led to declines in real rents, and problems multiplied. Lately, the cycles seem to be lengthening, and the structural vacancy rate that is observed before real rents start to fall seems to be going up. I think this is because of capitalizing interest. If a developer has to come up with his own money to make interest payments, he will cut rents to get the building occupied so he can pay. But if he can borrow money from a bank and use that to pay interest, he will keep his rents up. This sustains the length of the cycle, because it takes longer for excess capacity to be repriced. And it makes the ultimate drop in rents longer and deeper, since everyone is likely to cave-in at about the same time.

For example, consider the situation in Dallas. In 1981, the chairman of a brokerage firm said, "We are not there now, but we are going to go past the point of a healthy market, probably next year." There was nothing wrong with the demand for office space in Dallas - it went from 2 million to 80 million square feet in a decade. But supply went from 20 million to 120 million; that was the problem. The Dallas vacancy rate actually peaked in 1984. Real rents fell in 1986, which was when the market values of real estate fell precipitously. And the vacancy rate continued to go up after that.

We are seeing similar developments in a number of markets around the country, which have much higher capacity now than they did in the 1984-85 period, when real estate prices went up. In many of these markets, the vacancy rate has not yet peaked - which suggests to me that the market values for commercial real estate will continue to fall in the future.

Presently, U.S. commercial banks have almost $600 billion committed to leading activities which have been proven to have very high risk: $60 billion in LDC debt that has not been written-off; $150 billion in highly-leveraged transactions; and $380 billion in commercial real estate loans. The problems are depressingly reminiscent of the S&L crisis. I just hope that we can still avoid having the taxpayers pay this time around.

The continued decline in real estate values, of course, causes the cost estimates for the taxpayers for the S&L crisis to continue to grow. Since $531 billion in assets now reside in troubled thrifts (Exhibit 3), it is quite likely that the thrift crisis will cost us in the net percent value terms from $150 to $200 billion. But S&Ls are only part of the problem. If we want to worst case analysis, we might take a look at the liabilities of all insolvent or under-capitalized thrifts and banks together. If we add the liabilities of insolvent or near insolvent thrifts and banks together with those of under-capitalized thrifts and banks, we find that nearly a quarter of the $4.3 trillion in liabilities held by insured depositories, or roughly $940 billion, is in troubled or under-capitalized institutions (Exhibit 4).

Until recently, few were worrying about the health of the commercial banking industry because it had seemed to be relatively strong; during the 1980s, net interest margin before charge-offs actually grew slightly, despite the loss of income from the core deposits that either went to money market mutual funds or higher priced money market demand accounts and the high quality corporate loans that went to the commercial paper market. Even after we net out charge-offs, the net interest margin has declined only slightly.

But we have been enjoying a false sense of security, because when you take on excessive credit risk you front-end the income and the losses come later. Today's commercial banking industry holds a huge portfolio of risky loans, which I mentioned earlier, that adds up to well over $500 billion in assets of dubious quality.

Unfortunately, losses are now mounting fast. We have analyzed absolute charge-offs (as opposed to provisions) by year, from 1948 to today. In the last 4 years, the commercial banking industry charged-off about $75 billion. Some of that is LDC debt, but we do know that a great deal of LDC debt is still provided for, rather than charged-off. In contrast, during the entire period from 1948 to 1981, the industry charged-off $28 billion (Exhibit 5).

What is more troubling is that the industry's $75 billion in charge-offs came without a recession. Our analysis shows that in the past charge-offs have doubled in recessions - for example in 1969-70, 1974-75, and 1979-80. After each doubling, they typically continue to rise more slowly. What would happen to charge-offs now, if we had a recession? I believe they would go to more than $40-50 billion a year. More importantly, charge-offs would be concentrated, as they always are. About two-thirds of all charge-offs would be in 20 percent of the industry. If that happened, the capital of those institutions and the FDIC would be consumed.

THE CHOICE TODAY: WORK TO MAKE THE SYSTEM PROFITABLE?

Many of you share my concerns, and of course we are here today to help chart a course out of these troubled waters. As I said when I began, though, I am afraid that the steps taken in the future may work against the economic forces that are in motion - and will therefore further weaken the industry and the country.

I want to stress that I am not against some of the reforms currently on the table. Rather, I am convinced that if we stop at the level of deposit insurance reform and restriction of bank activities, we will both kill off the banking industry and damage our entire economy. On the other hand, if we set these reforms in the context of a fundamental restructuring to make the financial services industry profitable once again, we will help the industry, and the country, win. To explain what I mean, I will now describe two scenarios:

- The first is a base case, "muddle through" scenario in which we continue to make incremental changes in this system. This would protect political self-interest, but maximize national distress.
- The second scenario is based on fundamental redesign of the financial services industry, with regulation that works in concert with - rather than counter to - fundamental economic forces. It would result in better service to customers, profitability, and tax-paying - rather than tax-consuming - institutions. It would also allow for orderly liquidation of losing players and the orderly removal of overcapacity.

The "Muddle Through" Scenario

Today, risky lending is being constrained. Against a background of large budget deficits, the instinct of society, and lawmakers, is to prevent banks from making any more mistakes by just saying "no" to them - clamping them with more rules and making them pay for as much as the problem as possible. So far, we have seen a number of regulatory changes:

- We have a revised definition of Highly Leveraged Transactions.
- We have tough, and some feel unrealistic, examinations of real estate loans, with very conservative collateral assumptions, tough documentation requirements, tough accounting for interest reserves, and aggressive classification of loans as "in-substance" foreclosures.
- We are requiring institutions to put more capital behind their lending.

While such conservative regulation is desirable, it would have been more effective if it had been started several years ago. In the short term, these changes amount to a Catch-22 for this country's banks. On the one hand, they are being forced to collapse several years of losses under the old rules, into one or two quarters - which is destroying their capital. But on the other hand, they are facing higher capital requirements. The inevitable combination of less capital with higher capital requirements is less lending. At some point, you shoot past getting rid of just uneconomic risk and you start depriving borrowers who should have the money. When we do that, we risk doing our real economy major damage. If banks cannot lend, then individuals, small businesses, and mid-sized companies which have no other source of credit cannot grow. And they will not have safe depositories, either. The credit crunch has already deeply affected Texas and is now affecting New England, and it is not likely to stop there. I fear that if we do have a credit-induced recession, the impact upon our entire economy could be devastating.

Our regulators are, of course, quite aware of these risks as evidenced with their public discussions with bankers in which they have urged banks to keep credit flowing to all creditworthy borrowers. I do not envy the regulators their task. They are walking on a tightrope between being too strict or not strict enough.

With this as a context, I would like to respond to each of the questions you asked me in your letter of March 7, 1990.

Early Intervention

Early intervention to close or resolve failing depository institutions is critical as we think of ways to strengthen our financial system and reduce the overcapacity that exists today. We are now paying the price for all of the thrifts (and some commercial banks) that were kept afloat in the 1980s, when economic forces were working against them. Had a clearly defined early intervention policy been in existence at that time - with sufficient financial resources to back it up - we would be far better off today.

Two points are worth mentioning. First, the government should remove the capacity of failing competitors from the system. The natural outcome of competition is that some players fail. In the United States, however, the government safety net has kept losers in the system, who then overbid for deposits with government guarantees, thus raising the costs of deposits to everyone else. Rather than keep these insolvent institutions alive, the government should close them down.

Second, we should realize that government safety nets of any kind are a market anomaly. We should also recognize that retail depositors can not be expected to exert market discipline on depository institutions. Banks in fact are blind pools of risk. The essence of banking is the granting of credit to finance borrowers who lack access to credit markets. In those cases where the cost of securitizing credit exceeds the value of securitization, by definition these credits cannot be made transparent to the markets. Moreover, most banks' credit risks are too complex to be evaluated by the markets, leaving it to the regulatory examiners to judge on a loan-by-loan basis.

Therefore, the source of the market anomaly - the government - must regulate insured depositories to guarantee that the government is not exposed to loss from its safety net. Practically speaking, this means that the financial regulators will have to use a combination of tools (e.g., bank examinations, capital requirements, insurance premiums), not the least of which is a credible and known policy on the early resolution of troubled depository institutions. Such a policy would place limits on uneconomic risk taking and insulate the government from such practices.

In my book, Breaking Up the Bank, I argued for a green-yellow-red light system of early intervention on the part of the regulators. A green light flashing meant that a financial institution is in good standing with its supervisors, with sufficient capital and profitability to be a viable institution. A yellow light means there are some danger signals on the horizon and that both the regulator and the institution need to identify the source of the problems and take immediate steps to remedy the situation. Failing a successful recovery while the yellow caution light is flashing, a red stop light would appear, at which time the institution would be sold or liquidated.

While this may seem simplistic, it is critical that clear guideposts and criteria are established so that all institutions are on notice and have some comfort that insolvent institutions will no longer be tolerated. In fact, the examiners' CAMEL rating is one form of measurement, but other more publicly disclosed markers such as specific levels of capital and profitability also are good indicators that should be clearly known to all parties in advance. Refining early resolution policies is currently underway by the regulators and ought to be encouraged, without writing specific criteria into statute. However, a necessary step to making such early intervention work is to improve the accounting for bank assets and liabilities.

Market-Value Accounting

Market value accounting for depository institutions is suggested in a number of quarters as a way of adding accounting discipline to ensure healthy financial institutions in this country. After all, securities firms mark-to-market daily to account for a true market valuation.

Market-value accounting works for all assets and liabilities on a bank's balance sheet which are freely traded in the marketplace (e.g., investment securities). Unfortunately, while market value accounting in theory may have some appeal ordinarily, in practice it does not work for most important components of a depository institution's balance sheets. For example, market value accounting is difficult to apply to the core deposits of banks and thrifts, which often can have a significantly higher market value than their book value. Similarly, market value accounting can not be applied to a bank's commercial and industrial loans or commercial real estate loans since most of these are blind pool risks that either are not marketable or there are no established markets for them and hence no basis for an accounting measure at current market value. For these harder to evaluate assets, regulators and banks are finding that taking a net present value approach is helpful for evaluating otherwise hard-to-value assets (e.g., non-performing loans, demand deposit accounts). Historical value accounting is appropriate for performing loans.

I believe the use of a combination of market value accounting for marketable assets and liabilities with these other types of accounting will provide a more accurate assessment of capital for regulatory purposes than using only one approach or the historical value approach for all assets and liabilities. I also believe that market value accounting is appropriate for subsidiaries of the holding company which are principally engaged in the securities business.

Cross Guarantees

The subject of requiring cross guarantees between and among healthy and troubled parts of a banking organization has been a subject of intense debate in recent years given the growing number and size of failures of depository institutions, particularly commercial banks. The Federal Reserve has argued that cross guarantees apply implicitly within a holding company structure (a policy which recently has been invalidated by a federal appeals court), and the FIRRE Act codified the notion that healthy banks in an organization must come to the rescue of their failing brethren.

While such added protection from cross guarantees sounds attractive on the surface, it has the effect of making the balance sheet of the bank indistinguishable from the balance sheet of the parent or other affiliates. Moreover, it does little to contain the risks to which a depository is exposed and all too often attempts to force healthy units to pay up after the fact to lower the cost of resolution, in this case, to the FDIC. For reasons I will argue later, the use of cross guarantees is at odds with the system that I favor which is premised on containing risk in an insured depository institution.

Deposit Insurance Coverage

Much of the debate today centers around deposit insurance coverage. What is the appropriate level of coverage? Is $100,000 per account too much? Should individuals be treated the same way as corporations? Is there a role for some form of private insurance to complement FDIC coverage?

My starting premise is that people need a safe depository and a safe payments system. Since 1933, deposit insurance has become part of our social contract. It is therefore inappropriate to use depositors to instill greater market discipline or to treat them as investors. In other words, you cannot use the fear of failure as a means of getting market discipline from depositors. Investors make risk-reward trade-offs; depositors want to earn a risk-free rate of return. Moreover, it would be extremely difficult to balance the proper level of depositor discipline at any one point in time. If there were any doubt in the system or any fear, then a bank panic could ensue and that in itself would create a larger social evil.

With this notion in mind, it is probably more worthwhile to spend time and energy devising ways to limit risk in a depository institution than it is to tinker with the proper level of coverage in any single account. Is $100,000 per account about right? Should it be $75,000 or $40,000, as it once was? While I would not want to see the level increased beyond the current statutory amount, I believe we should focus our attention on the fundamentals, that is, ensuring that the government does not absorb risk that should be borne by the marketplace. As I will suggest later, there are better ways to accomplish this structurally and enhance the franchise value of depository institutions at the same time.

While the members of this Committee are better political experts than I would pretend to be, it is my assumption that efforts to tinker with deposit insurance coverage levels would be viewed with a great deal of skepticism by the public at large, which has come to view deposit insurance as something of a Constitutional right. Experimenting with the "appropriate" levels of coverage could also add a high degree of instability in our system at a time when financial stability is needed. Moreover, efforts to lower the level of coverage or limit the type of coverage could result in lower premiums paid and a smaller FDIC fund to absorb future problems. For these reasons, it is more productive in my opinion to focus on limiting risk in a depository institution than to spend time and political capital on the issue of changing levels of deposit insurance coverage.

Risk-Based Premiums

Risk-based premiums have been a topic under consideration since at least 1982 when the Congress asked the regulators to review the practicality of risk-based premiums and report back with recommendations. A year or so later the agencies reported their results to Congress and, while I will oversimplify to make my point, generally concluded that in theory they would like to have the flexibility to impose risk-based premiums, but would work out the details at a later date.

In my opinion, the theory behind risk-based premiums is compelling: our flat rate system of deposit insurance premiums is one of the reasons we are having problems today as weak institutions take more risk to earn profits and get paid the same insurance premium as more healthy, conservative institutions. Therefore, theory would dictate that a risk-based system (perhaps analogous to risk-based capital guidelines) would correct the shortcomings of the flat-rate system. Yet, when it comes to devising practical, uniform measurements or deciding how precisely such a system would be implemented, the theory breaks down. This is one of the reasons I believe that we have not moved to such a system in the past 8 years since Congress first asked the question.

If applied *ex ante*, such a system imposes enormous responsibilities on examiners and whatever measurement tools they use to assess the "right" amount of risk. In turn, based on the examiners' determination of the "right" level of risk, a significant financial burden could be placed upon the institution based on the examiner's reports. If applied *ex post*, such a system could hinder the ability of new management teams of troubled institutions to restore the institution to economic health or, at an extreme, drive marginal institutions to failure. While I have argued throughout that market forces should control which institutions remain as competitive players, I do not favor a risk-based premium system imposed by regulators and examiners as a substitute for market discipline of the kind I envision and will describe later.

Too Big To Fail

Is any depository institution too big to fail? The answer is probably no, but to date the federal financial regulators have not been willing to let larger depository institutions "fail" in the sense that some smaller banks and thrifts are simply closed and depositors are paid off up to the insured amount. Perhaps with good reason, the regulators have not wanted to flirt with systematic risk and the possible ripple effects on other bank and non-bank customers that could result from the failure of a large, multi-billion dollar institution.

Two points are worth mentioning in this context. First, there is a need to narrow the risk-taking in all insured depositories, large or small. I will expand on this point in the last section of my testimony. Second, we need to ensure an orderly process for the resolution of large financial institutions. Such procedures may not have been in place at the time of the Continental Illinois crisis, but the government by now has enough experience to have procedures, personnel, and systems in place to manage an orderly resolution process. While not a commercial bank, Drexel Burnham was managed by the government in a way that prevented any sizeable disruption in our financial markets. The Drexel case did require Federal Reserve and SEC intervention, but an orderly liquidating process was observed and it demonstrated that people providing the capital took the loss. With the recent "bridge bank" authority granted to the FDIC by the FIRRE Act and with the other sweeping powers already conferred on the federal financial regulators, it should be reasonable to assume that an orderly process for large financial institutions is in place today, even if it is not entirely observable to the public ahead of time.

To sum up, I think that some of the proposals you asked me about might be beneficial, but these actions alone certainly will not resolve the problems in our financial system. Even if we make all these reforms, we will still have artificial boundaries between the bank and thrift industries (which now perform the same kinds of business) and between commercial banking and investment banking (which also now perform the same kinds of business). We will still be left with artificial geographic boundaries. We will still be protecting uneconomic players from failure. We will not eliminate marginal capacity, and thereby we will continue to destroy the franchise value of institutions. Potentially, we will continue to interfere with capital flows, over-regulate banks, perhaps overcapitalize banks, and raise deposit insurance premiums needlessly. In short, we run the risk of continuing to try to overcome fundamental economic forces that are much more powerful than regulation could ever be.

I don't like to contemplate the future of this "muddle through" approach but I'll sketch it out for you.

- Dozens of medium-sized, inefficient banks (analogous to today's steel industry), unable to raise capital, uncompetitive in global markets

- Most financial activity flowing outside the banking system, into more efficient and effective channels

- Winners in disaggregated businesses will be non-banks

- Small businesses, mid-sized companies, and individuals will be served more poorly since there is no effective non-bank alternative for delivering many banking services to these customer groups

- Extreme repricing of loans, leading to a credit crunch or a prolonged recession

- Increased cost of the deposit insurance debacle to stretch the nation's financial capacity

- And we will see a loss of competitiveness of the United States as a nation (particularly in those sectors where small and mid-sized companies play a major role).

Fundamental Reform

Because the events affecting the financial services industry receive so much coverage in such publications as the Financial Times, the Wall Street Journal, the Economist, and Nikkei Business, it is easy to underestimate just how much structural change in the financial industries structure is still ahead of us. Indeed, the changes that have occurred so far are little more than a prologue to the changes that lie ahead. The real transformation of the financial services industry still lies in the future.

As I have indicated, most of this change is being driven by the unleashing of market, economic, and competitive forces resulting from fundamental changes in the law and regulation governing the world's financial institutions. In turn, changes in law and regulation are being driven through fundamental changes in the techniques of production (i.e., technological changes), which have made much existing law and regulation obsolete.

Changes in law and regulation are perhaps the most important single environmental force at work now simply because the heavy regulation of financial institutions has been the chief determinant of industry structure throughout the world by determining where and how each participant could compete. This, in turn, shaped overall industry economics and the economics of individual companies. At the industry level, any significant change in regulation therefore profoundly affects competitive equilibrium. At the participant level, any significant change in regulation directly affects the viability of the participant's business system and economics. It may even affect the participant's very role and ability to remain independent.

In most countries of the world, regulators and legislators have tried to moderate the effect of fundamental economic forces (i.e., changes in technology, markets, and competitive practices) on their national financial services industry through reactionary regulation (i.e., regulation designed to preserve the status quo rather than to accommodate economic forces). When these regulations eventually become unworkable, the then inevitable rewrite of regulation causes explosive change. In country after country, this period of rapid restructuring is coming nearer and nearer. In the United States, it is already well started. Moreover, it now appears that the period of reactionary regulation of financial institutions is coming to an end almost everywhere in the world. It appears inevitable that there will be fundamental, continuing, changes in the laws and regulations governing financial institutions in almost all nations of the world throughout the next several years.

What we need, again, is a system that recognizes and works to capitalize on the basic economic forces of consolidation, securitization, and disaggregation. To that end, the basic rules I would suggest are as follows:

- The natural franchise of banks is to attract local deposits with government insurance and to protect the payment system - for everybody.

- Customers should pay for safety. That means they should receive less interest for government-insured deposits than for uninsured deposits. The income from taking insured deposits should help pay for the protected system.

- Assets should be allocated to economically viable activities, without the distortion of government social agendas, and priced to earn a profit commensurate with the level of risk in the activity.

- Laws and regulations should be designed to enable fundamental economic forces to work unhampered, except insofar as they endanger the payments system or threatened the social contract to protect insured deposits. That means removing artificial barriers like the Glass-Steagall Act, which has for a decade been trying to maintain a distinction between investment banks and commercial banks - a distinction that securitization has all but erased. It also means removing the distinction between banks and thrifts, and eliminating the McFadden Act and the Bank Holding Company Act.

If we designed a system along these lines, I believe the end-game could look very different.

- Ten to fifteen highly skilled "national" (i.e., multi-regional) bank/bank holding companies would evolve, each with $250 billion plus in deposits and high profitability by the late 1990s. These institutions would rival those of any nation.

- We would lose only those funds from the banking system to non-banks competition which offer customers better service at less cost (e.g., those customers who did not want branch-based, insured deposits could put their money in money market mutual funds).

- Our banks would have expanded national opportunities in "disaggregated" businesses and non-banking businesses. Some players would go outside their historical charters and make a lot of money in elements of the business system on a national basis.

- We would reprice terms, conditions and the availability of high risk assets so that, for example, commercial construction would still be possible, although priced to deliver profitability to the lender most likely through a commercial finance subsidiary or affiliate.

- We would minimize the cost of the federal deposit insurance debacle, by strengthening the solvent institutions that remain (rather than pushing them over the edge) by having economically viable participants continuing to pay deposit insurance premiums in the future.

- We would have a healthier, and more competitive, real economy.

THE PROPOSED REFORMS: BUILDING A SMARTER MODEL FOR A NEW INDUSTRY

Because we need to restore the franchise value of our banking industry, I believe that we should stop concentrating on fine-tuning a system that is flawed and start concentrating on the design of a smarter system for the future that will work and keep banks profitable. Again, this redesign of our system is set in a context where the fundamental problem is that the government absorbs risk that should be borne by the marketplace.

I believe that the fear of losing one's money causes people to weigh carefully risk/return trade-offs. The evidence that this belief is true is very powerful. Where that fear exists, we have strong financial institutions. I think it is remarkable that there have been almost no major insolvencies among that part of the financial services industry disciplined by the marketplace. American Express, General Electric Credit, Ford Motor Credit, IBM Credit are all pillars of financial strength. Not a single money market fund has had even the whisper of a problem. Of over 1,000 mortgage-backed securities transactions, only one has got into trouble.

On the other hand, insured depositories, including not just savings and loans but commercial banks as well, have been assuming risks that the marketplace would never have allowed them to take if investors' funds had been at risk. Yet, since insured depositories are allowed to bid whatever they want to obtain funds we provide depositors with the opportunity not just to earn a risk-free return, but a very high rate, as well. This is the fundamental anomaly in the system. We allow the least skilled financial institutions to raise as much money as they want and to take whatever risks they want. Curing this problem is what deposit insurance reform is all about.

Our goal should be to design, probably from the ground up, a financial services industry without artificial boundaries, without duplication of efforts, and without any more regulation than we need to ensure the integrity of our deposits and our payments system. As we search for a new model, it probably makes sense to begin by looking at the spectrum of approaches in use today around the world.

The spectrum extends from our holding company model, with legal boundaries that seek to separate different types of financial services into separate institutions, to the universal banking model that has done so well in Europe up to now (Exhibit 6). The universal bank model, though, will be as uncompetitive as our own going forward. The reason the universal bank is uncompetitive is because it shares costs across a broader spectrum of financial services than the U.S. model does, and therefore mitigates against the forces driving the industry. There is a variation, where the bank itself is the owner of the regulated subsidiary. In this variation banks would own a securities firm, an insurance company, a real estate company (Exhibit 7). The Canadian banks and Barclay's have been able to set up securities affiliates using this model, and there is a high likelihood that Japan will move this way.

Core Banks With Expanded Holding Company Powers

Now, let's think about variations that have not been tried yet. Here I should say that my thinking has progressed since I wrote the book, Breaking Up the Bank, in which I proposed a risk-free banking model. I have moved away from that, to a model that includes a segregated, "core" bank within the holding company (Exhibit 8).

In this revised model, the core bank is a segregated, regulated, FDIC-insured bank that would have some significant limits on how it operates in the future. The reasonable quid pro quo, however, would be that the holding company would have expanded freedom to engage in new financial activities outside that core bank. That is, the financial holding company could include both a core bank and a separate securities subsidiary, which would be a wholesale/money market/investment bank. In this bank, non-qualifying assets of the core bank (e.g., commercial real estate, highly leveraged transactions, etc.) would be funded from the market place, rather than from FDIC-insured deposits. Market discipline rather than regulation would keep this wholesale bank whole - or else investors would lose their money, not the FDIC. To prevent financial panics, this wholesale bank would have a Federal liquidity line. Let me describe these two kinds of banks for you (Exhibit 9).

First, the core bank. The natural customers of the core bank are individuals, small businesses, and mid-sized companies. Its core business is to lend to these customers, and to provide these customers with convenient and insured deposits and transaction balances. We need this kind of bank because it adds economic value to this customer set, because we need to protect the payment system, and because I believe there is a social contract that deposits from individuals should be made safe by the government. This social contract is the reason and justification for the anomaly in the marketplace called deposit insurance. The government has the mission of keeping the FDIC-insured bank economic and protecting it, and that means restricting market forces in that one enterprise to maintain its continued franchise value (Exhibit 10).

To carry out that mission, we have to change some things. Probably most important, we have to take brokered deposits out of this system and remove the barriers to consolidation that are preserving overcapacity. The natural franchise of a core bank is insured deposits,and convenience. Brokered deposits erode that natural franchise, awarding deposits to the highest bidder - whether or not, as we have seen, that bidder knows how to use those funds productively.

We need to stop the uneconomic flow of funds to those weak and failing institutions that have been taking excessive risk - and make sure that insured deposits only go to strong, prudent core banks. Brokered deposits are causing this country, and its banks, more and more trouble. In fact, with the creation of the Resolution Trust Corporation (RTC) the primary source of brokered deposits is not institutions, but the government, which has not closed down the failing institutions because of budget pressures. The RTC is brokering more deposits, and this amounts to an indirect tax on competing, healthy institutions by bidding up their cost of funds in local markets. At the same time, many bank customers have become "interest rate junkies" - arbitraging the government by moving their money many times a year, always to the insolvent institutions that offer the highest returns. We have to close this abuse down.

Now, let's talk about consolidation and overcapacity. Like it or not, a business like this will work most cost effectively as a natural local oligopoly, with some competition within that oligopoly. We will all be better off if these banks work to get their shared costs of serving the community down, and become profitable. But the natural local oligopoly I am talking about here would be different from the old one, where people had no other source of financial services but community banks. In this model, the natural oligopoly would be the only source of insured deposits. With the non-bank competition we have now, if a core bank became uneconomic to customers and exploited its local market, it would lose its market share to money market funds and other non-bank competition.

If a core bank loses its independent viability, we should get it out of the game. To the extent this business consolidates for economic reasons, the government should let it happen, and not discourage it. This is the key to removing the overcapacity in the system and restoring profitability.

I have said that to fulfill their social contract, we must give these institutions FDIC insurance. In return, we have a right to expect prudence. That means maintaining sufficient, regulatory mandated capital, paying adequate levels of deposit insurance premiums, and getting out of the businesses that have led to trouble in the past - including, I would suggest, high risk loans (e.g., commercial real estate loans as underwritten during the last decade) and securities above those needed to support customer liabilities.

The core bank should continue to use historical value accounting, because there are no markets for all of the products it offers - if there were, all parts of the balance sheet would find market values through the securitization process. But the core bank should use better historical accounting than we have seen many of our institutions using recently. Our real estate problem was not that we did not use marked-to-market accounting, but that we perverted accounting practices - through capitalized interest, the use of high appraised values based on artificially high estimates of rents and tenancy rates, and artificially low cap rates which result in an inflated value of the property.

Further, the core bank should be forced to adopt more prudent credit terms and conditions than we saw during the 1980s, and I think our regulators need to address this now. They will do it better if they work with the Credit Standards Advisory Committee, which should have private sector credit specialists on it under the terms of the FIRRE Act. Ideal candidates for membership on this Committee, I think, would be the chief credit officers of the best lending institutions in the country. In my view, the sooner this advisory committee begins suggesting prudent credit guidelines that would be known by lenders and the borrowing public, the better off the country would be.

By the way, you will note that this model includes a commercial finance company, held by the financial holding company. This is where I would suggest that higher risk loans be made, funded in the financial markets, at prices that reflect its cost of money and its cost of capital. I would envision the majority of commercial real estate lending and highly leveraged finance transactions would be done by such commercial finance companies. Yes, these loans would be more expensive and would require more equity from developers. The point is that they would be worth making only if the project was going to be economic.

If you have an economic core bank that adds value to customers and you only allow it to take credit risk that is approved by regulators, that core bank will be fundamentally profitable if it has scale. The right scale is not the government's business, other than letting it happen. By the way, I do not think the model I am proposing will necessarily do away with all small community banks. There are smaller community banks that are doing quite well against the regional banks, as long as they are well-run. Where they do particularly well is in serving communities that want - and can pay for - more service. So I want to emphasize that I do not believe we should wipe out small banks, but I am saying we should not protect them because they are small. If we do that, we will hurt other small players, i.e., small businesses. Protecting institutions that are no longer viable does no social good.

Wholesale/Money Market Bank

Now, let's talk about the other bank, the wholesale/money market bank. This bank would serve corporations, institutions, and governments, with a broad variety of commercial banking and investment banking products. This bank would operate in both the money and securities markets, buying, selling, underwriting and distributing both debt and equity securities. That is, this model would eliminate the now obsolete distinctions created by Glass-Steagall and create one kind of wholesale financial institution, with one body of regulation. I personally have no opinion about whether the Federal Reserve or the SEC should regulate it, as long as the regulation is coherent and functional. Further, that regulation should only extend to rules that help the market forces work.

The deposits in this wholesale bank would be inter-bank deposits and large uninsured CDs. These deposits are clearly important for the health of our financial system, but there is not enough profit in the wholesale business to cover a potential 33 basis point deposit insurance premium. The spreads between bid and asked-for many wholesale assets are less than that today. Yet, we obviously need financial institutions making markets on their own balance sheets in these assets. So, how do we protect these large deposits and ensure that these institutions make prudent decisions? By doing two things:

- First, all assets would be marked-to-market daily, which will limit the ability of these institutions to take risk. For the purpose of market-making, these banks would be allowed to have limited non-marked-to-market assets. Some of these non-marked-to-market assets might be loans. But regulation would require them to have a 1-to-1 (or another safe) match-off of capital (e.g., in the form of non-callable bonds with 20 year life, or non-callable preferred stock, or equity) against those assets. Because these banks by definition would operate in the securities markets, where there are short-term, liquid instruments and you know what each item is worth, marking assets to market would be feasible.

- Second, these banks would have a liquidity line from the Federal Reserve to protect against liquidity crises like the stock market crash.

These safety nets would work to keep depositors whole, and lay the burden of losses on investors in these institutions, as follows: The Federal Reserve would have a discount window open to these wholesale banks, and it would take preemptive collateral each time the line is used. That is, the Federal Reserve would lend money, but take possession of enough securities to protect itself.

If liquidation became necessary, it would be handled in the same, gradual, value-preserving way that Drexel Burnham was taken down, over two to three weeks, through the orderly liquidation of assets. As happened with Drexel, any losses would be borne by the capital holders, rather than the taxpayer. But I would recommend that we have better laws that: (1) define qualifying capital, specifying that capital providers take their money out only after the Federal Reserve liquidity line and then other creditors have been paid off; and (2) restrict the ability of the holding company to move money around its various subsidiaries, as was done with Drexel, for the purpose of eluding or postponing recognizable losses.

I am confident that we can have healthy wholesale institutions without deposit insurance, because this country has a host of non-bank competitors - regulated by the SEC and by their markets - which are extremely strong and profitable without it. When major restructuring has been needed, as in the case of Drexel or Shearson, it was done in an orderly way, without a panic, and with losses taken by the capital holders. I see no reason why this wholesale bank could not work in the same way within a new financial holding company model.

A New Holding Company Model

Of course, this model raises issues not only about who should regulate each entity, but also who might own each entity. I would recommend a model in which a financial holding company, which could include a core bank and a wholesale bank, might in turn be held by a holding company which had no restriction on which other subsidiaries it might own (Exhibit 11). I realize that there are historical arguments against this approach, but I go back to what I said about the need to recapitalize this industry. If new capital does not come from non-traditional sources (i.e., commercial enterprises), then where are we going to get additional capital to recapitalize the industry?

The question is, how would financial institutions finance assets that do not qualify to be funded with federally insured deposits or with deposits protected by a liquidity line from the Federal Reserve? The vehicle for doing this would be a financial holding company, which, in fact, is the quid pro quo necessary to make the core bank concept workable. In fact, I believe it would be a major mistake to undertake deposit insurance reform without also moving to a financial holding company concept (as opposed to a bank holding company concept). Under the financial holding company concept, a holding company could own both federally insured and non-insured subsidiaries. The holding company (and its non-insured subsidiaries) would raise money from investors in the marketplace based upon its capital, its earnings strength, and the quality of its balance sheet.

Firewalls would be used to keep risks taken by a financial holding company or its subsidiaries from affecting the soundness of its insured depository. In this model the regulators would have the authority to establish intercompany financial firewalls to prevent either the abusive movement of financial assets out of the core bank or the transfer of excessive risk into the core bank. For example, intercompany transactions such as dividend payments, management contracts, service agreements, and guarantees would be monitored and regulated by the federal authorities. Financial transactions that were conducted on an arms length basis and fully collateralized would be permissible under supervisory control. Other types of "firewalls," such as restrictions on the cross-marketing of products or the use of common names, have no economic justification and would not be permissible in the model I am proposing.

This approach would reintroduce market discipline to limit unwise risk taking. Risk taking that did not qualify for FDIC-insured depositories would have to be financed through funds provided by investors to subsidiaries of the financial holding company. Investors would, of course, demand higher rates for their uninsured investments - but market prices for financing higher credit risk activities would also rise, since uneconomic risk-taking by "dumb" insured depositories would no longer be available to finance such risks. Only financial holding companies which had the capital and the skills to persuade financial and capital markets that they could underwrite such risks would be able to raise funds without federal deposit insurance.

Moving from industry regulation to functional regulation, which is what I am describing, will not be easy. But I think expending the effort now will eliminate a huge number of problems as we move forward and financial services continue to evolve. Functional regulation, where everyone in a business follows the same rules, will allow the industry to evolve with economic forces, rather than against them. We need regulation that says, you can be in any business you want to, but if you get into the core banking business, with insured deposits, you must always play by this one set of rules for core banks. With this kind of level playing field, competition will deliver the best value to customers, and the best economics to the most effective competitors.

As I have testified in the past, it would probably take us 3 to 5 years to get from where we are now to the system I have just described. To sort out in an orderly way the various types of assets and deposits now in our financial institutions, we would begin by telling all creditors that 3 or 4 years from now the government will stand behind only those liabilities that reside in the core bank - and that the market will discipline the rest. Existing loans would be grandfathered to smooth the transition process to the new system I have just described.

CONCLUSION

I began my testimony by stating that we are at a crossroads in our Nation's financial history. We have some fundamental choices to make, hopefully soon, and the decisions are ours to make. We can continue to resist the basic economic forces I have described today and "muddle through," but this approach leads to a whole host of negative results, like more uneconomic risk-taking, that will flow through to adversely affect the real economy. Or, with some concerted effort, we can move ahead and undertake significant, long overdue regulatory reform to take us into the 21st century.

To embark on the course I have outlined today as my preferred approach, we must first recognize and then protect the basic franchise value of our depository institutions. Because we have this market anomaly called deposit insurance, the U.S. government has a major stake in ensuring that the basic banking unit - which I have called a core bank - operates safely, efficiently, and profitably. Truly acting from this basic premise is perhaps the single, most important step we can take toward real deposit insurance reform.

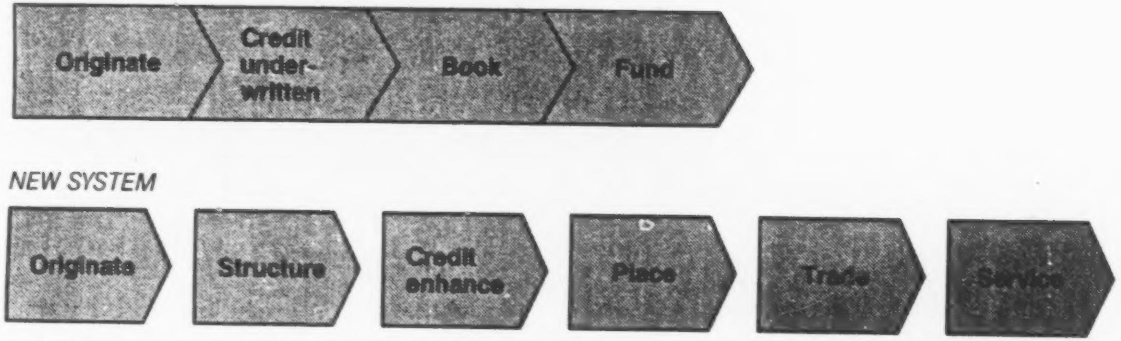
To be sure, certain other elements of deposit insurance reform - such as a credible policy on early intervention to resolve troubled institutions, better accounting practices, and the elimination of brokered deposits - would be important markers along the reform path. But a fundamental restructuring of our banking industry is required in the future to prevent uneconomic risk-taking, which in the final analysis is what our deposit insurance system is all about. By moving toward a smarter structure - one that embraces a holding company model with greater competitive opportunities in exchange for moving toward a core banking unit to reduce the exposure to the government's safety net - we will be on a course to a safer deposit insurance system and a world where a world-class banking system provides the infrastructure for a strong real economy.

Exhibit 1

SECURITIZATION

TRADITIONAL COMMERCIAL BANKING SYSTEM

NEW SYSTEM


Originate
Credit under-written
Book
Fund
Originate
Structure
Credit enhance
Place
Trade
Service

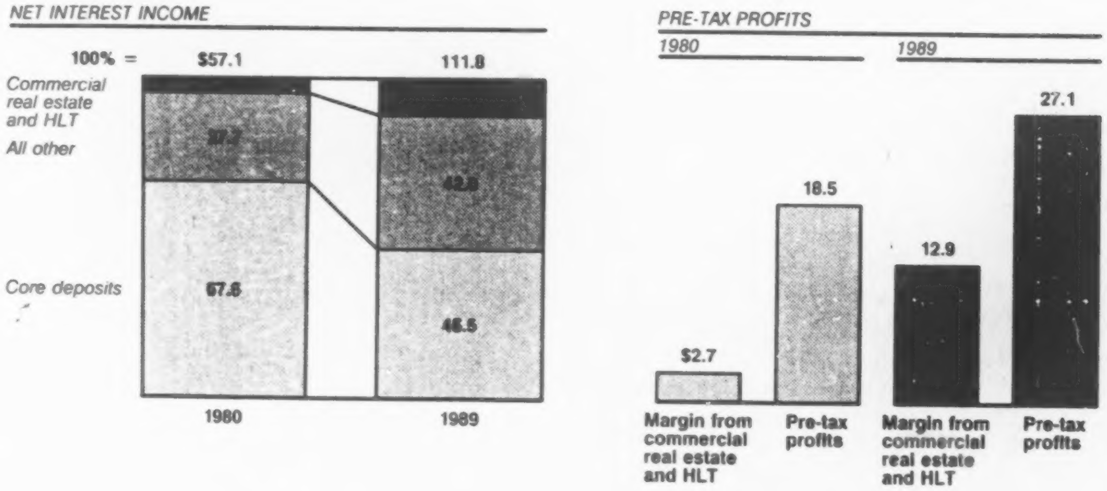
Originate	Structure	Credit enhance	Place	Trade	Service
• Thrift • Commercial bank • Retail securities firm	• Investment bank • Retail securities firm	• Insurance company • Foreign bank	• Pension fund • Thrift • Insurance company • Individual	• Investment bank • Commercial bank	• Investment bank • Commercial bank • Specialist payments processor

Exhibit 2

CONTRIBUTION TO NET INTEREST INCOME AND PRE-TAX PROFITS

$ Billions

ESTIMATE

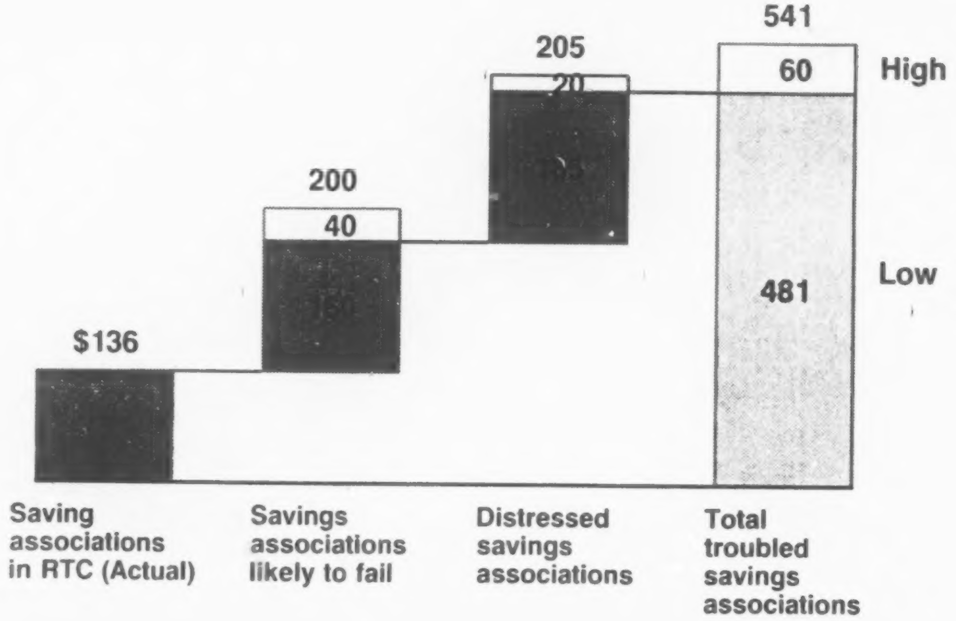


Source: Federal Deposit Insurance Corporation, Call Reports; McKinsey analysis and estimates

Exhibit 3

TROUBLED SAVINGS ASSOCIATIONS

$ Billions of assets

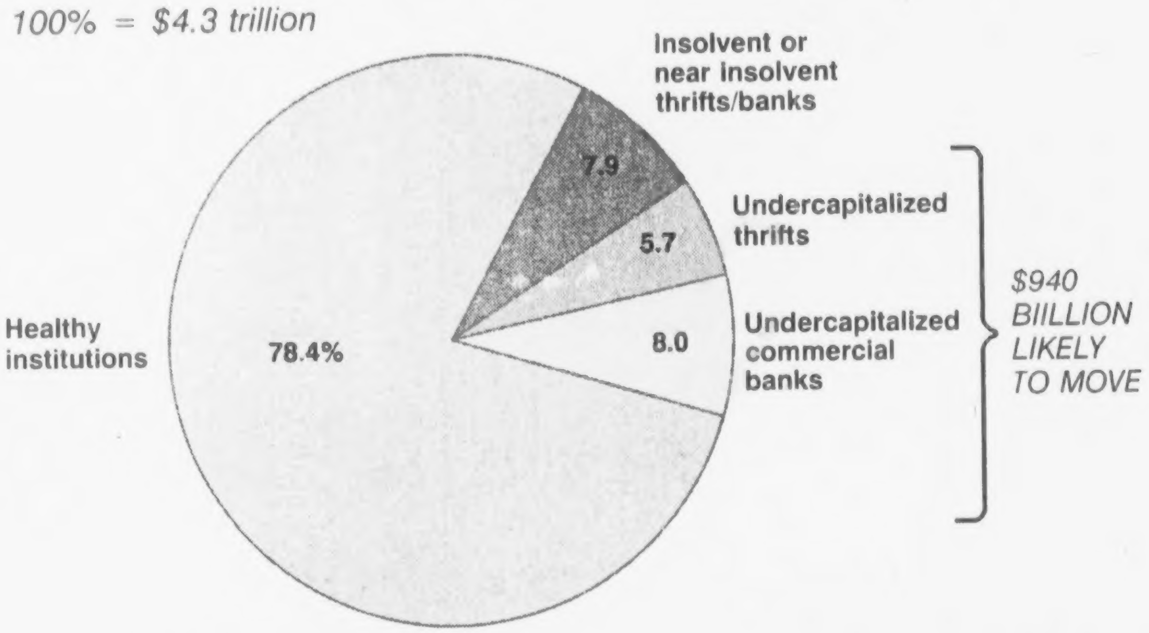


Source: Resolution Trust Corporation; McKinsey analysis

Exhibit 4

1990 LIABILITIES TO MOVE?

$4 trillion liabilities, insured depositories

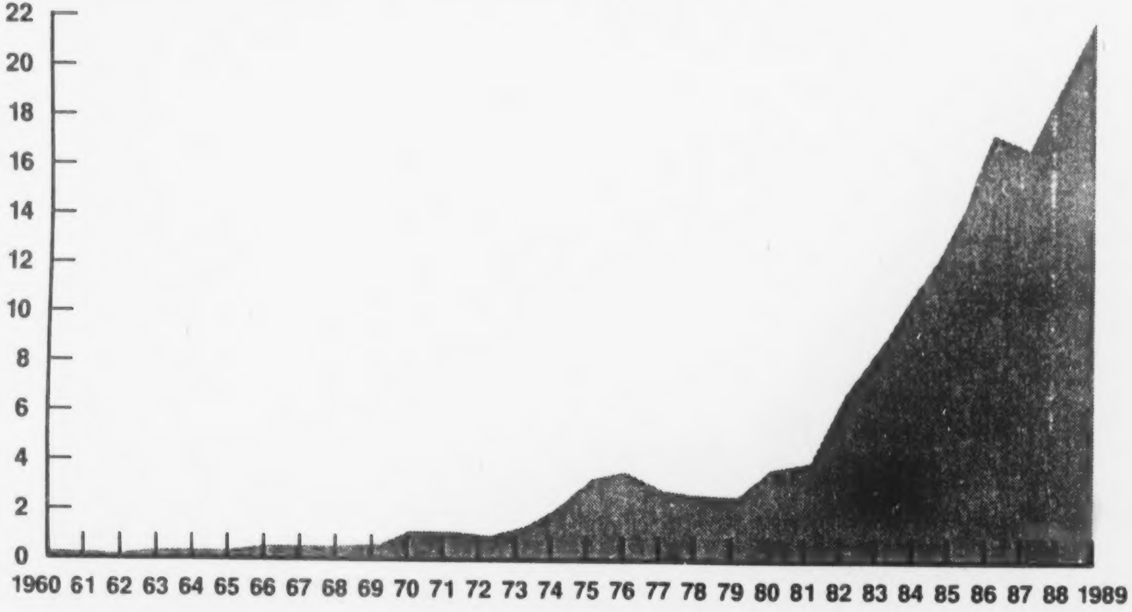


Source: Federal Deposit Insurance Corporation, Call Reports; McKinsey analysis

Exhibit 5

COMMERCIAL BANKS: EVOLUTION OF NET CHARGE-OFFS 1960-89

$ Billions



Source: Federal Deposit Insurance Corporation, Call Reports; McKinsey analysis

Exhibit 6

"UNIVERSAL" BANK VS. BANK HOLDING COMPANY

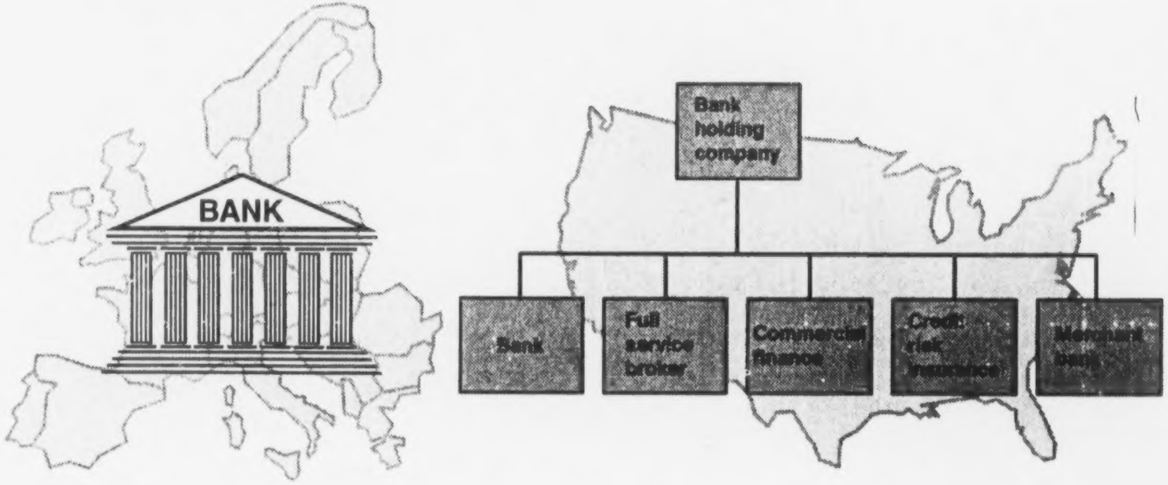
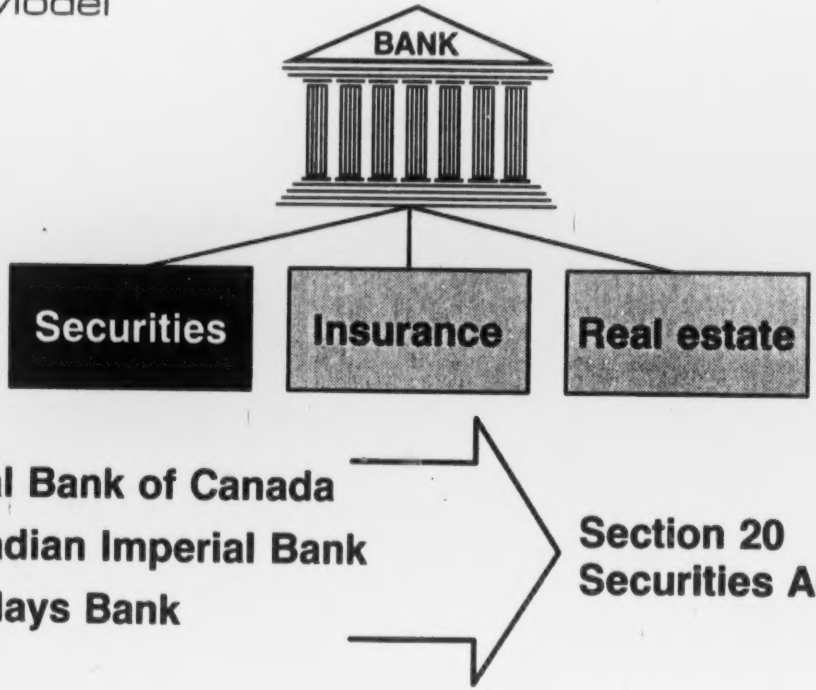

BANK
Bank holding company
Bank
Full service broker
Commercial finance
Credit risk insurance
Merchant bank

Exhibit 7

UNIVERSAL BANK:

U.S. Model



BANK

Securities

Insurance

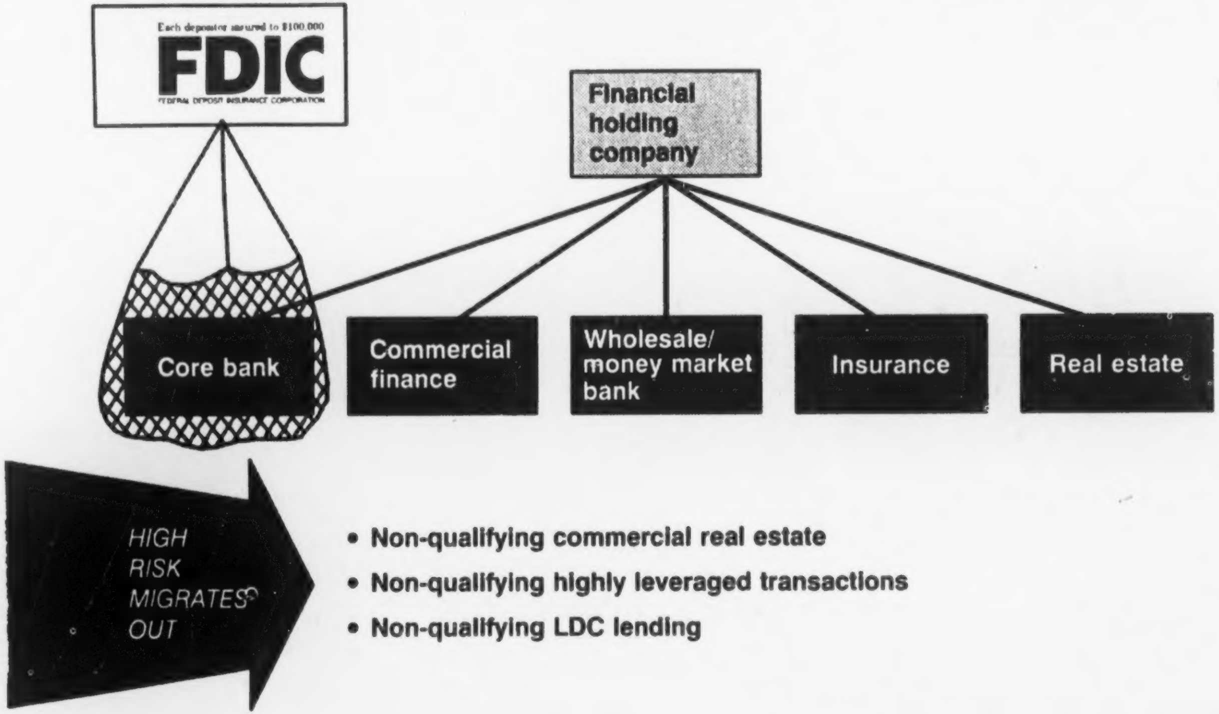
Real estate

- Royal Bank of Canada
- Canadian Imperial Bank
- Barclays Bank

Section 20
Securities Activities

Exhibit 8

FINANCIAL HOLDING COMPANY MODEL



Each depositor insured to $100,000

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION

Financial holding company

Core bank

Commercial finance

Wholesale/ money market bank

Insurance

Real estate

HIGH RISK MIGRATES OUT

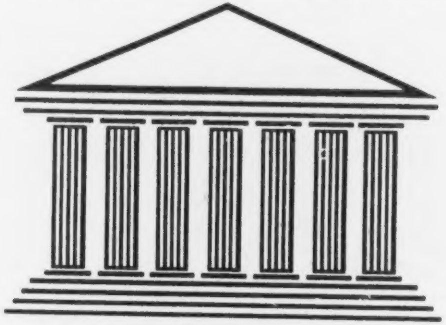
- Non-qualifying commercial real estate
- Non-qualifying highly leveraged transactions
- Non-qualifying LDC lending

Exhibit 9

ALTERNATIVE SEGREGATED BANK MODELS

CONCEPTUAL

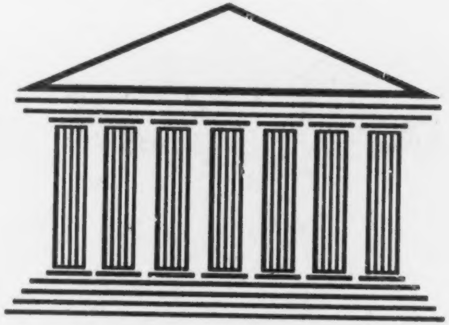
WHOLESALE/MONEY MARKET BANK



- No deposit insurance
- Marked-to-market accounting (Limit on non marked-to-market assets to capital)
- Federal Reserve liquidity line
- Market determines lending standards, subject to capital

V.

CORE RETAIL BANK



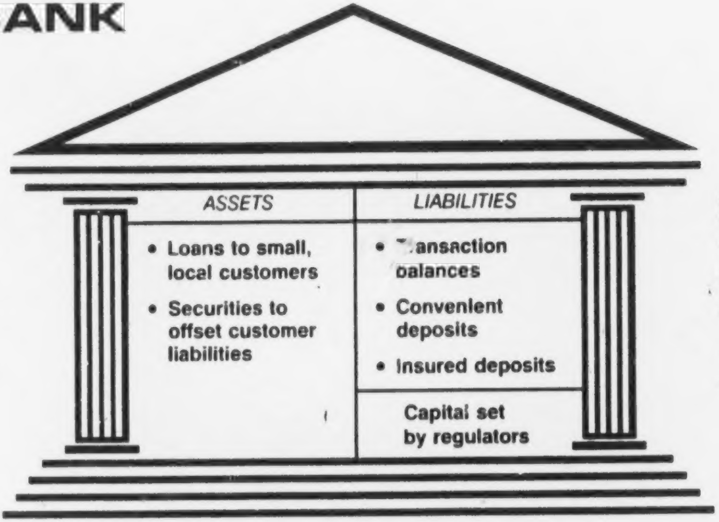
- Deposit insurance
- Historical value accounting (If assets held to maturity)
- Federal Reserve liquidity line
- Lending standards and capital determined by regulators

Exhibit 10

CORE BANK

NATURAL CUSTOMERS

- Individuals
- Small businesses
- Mid-sized companies


ASSETS
Loans to small, local customers
Securities to offset customer liabilities
LIABILITIES
Transaction balances
Convenient deposits
Insured deposits
Capital set by regulators

COSTS

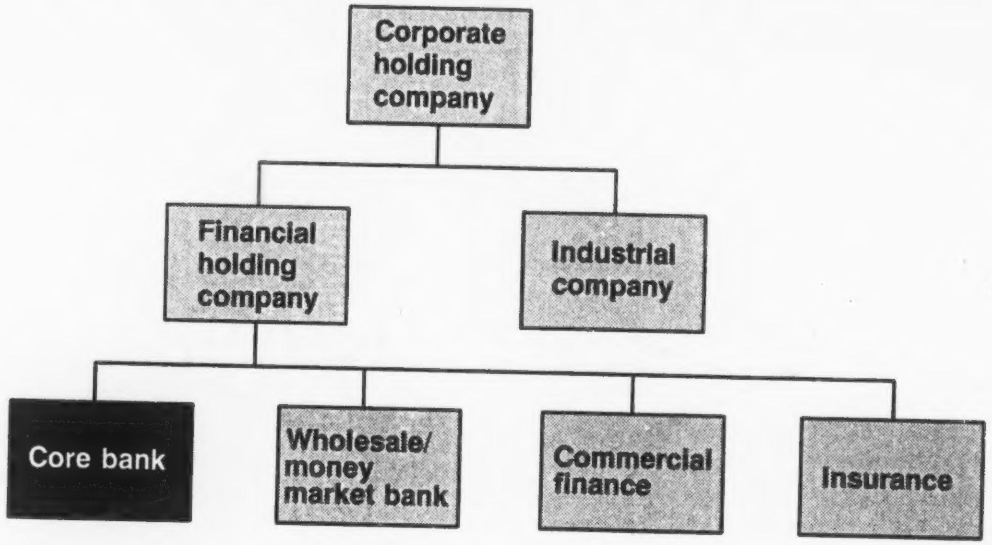
- Branches/ATMs
- Payments system
- Custody
- Deposit insurance
- Reserves

- High risk loans?
- Securities above those needed to offset customer liabilities?

- Price-sensitive liabilities?

Exhibit 11

FUTURE HOLDING COMPANY MODEL?


Corporate holding company
Financial holding company
Industrial company
Core bank
Wholesale/ money market bank
Commercial finance
Insurance

The **Chairman**. Mr. Kaufman, we are delighted to have you, and we would like to hear from you now.

STATEMENT OF GEORGE G. KAUFMAN, JOHN F. SMITH, JR. PROFESSOR OF ECONOMICS AND FINANCE, LOYOLA UNIVERSITY OF CHICAGO, CHICAGO, IL

Mr. **Kaufman**. Thank you, Mr. Chairman.

I am pleased to testify on deposit insurance reform. Many of the current problems in the commercial banking and thrift industries and much of the cost of these problems are attributable to the flaws in the design of the existing Federal deposit insurance structure.

It has been often and well documented, the existing structure encourages risk taking by both insured institutions and insurance agencies.

You have asked me to discuss six issues related to the proposed cures. In my written statement I do so. In this summary I will focus only on the first question regarding early regulatory intervention to minimize the probability and costs of bank failure.

Early intervention in capital maintenance is my personal and the Shadow Financial Regulatory Committee's preferred solution. It deals directly with the two most costly features of the existing deposit insurance structure, too little private capital in banking and the potential for continued operation when banks are insolvent, and would impose the least cost on either the banking system or the taxpayers.

It combines the best feature of the pre-FDIC structure, market discipline, with the best feature of the post-FDIC structure, protection against the systemic currency run on the banking system as a whole.

Only when a bank losses exceed the amount of capital will they be borne by uninsured depositors or the deposit insurance agency. Before the FDIC, all depositors had all their deposits at risk and demanded that the banks hold sufficient capital to cushion the shocks they were likely to encounter. Thus, in the early part of this century bank capital ratios were near 20 percent.

In addition, shareholders at all national banks and some State banks were personally liable for an additional amount up to the par value of their shares. As a result, contrary to current popular belief, bank failures were relatively infrequent until the 1920's. Indeed, from 1875 through 1920 the bank failure rate was lower than the non-bank failure rate. Moreover, losses to depositors at failed banks averaged less than 0.2 percent of total bank deposits per year and remained below 1 percent even in crisis years.

The introduction of Federal deposit insurance reduced depositor concern about the safety of their funds and permitted banks to reduce their private capital ratio sharply to near 6 percent. It does not take much of a shock to wipe out 6 percent of a bank's assets.

Unfortunately, the increased instability in the macroeconomic performance in recent years, coupled with fraud, managerial and regulatory inexperience with new powers and inadequate regulatory monitoring and supervision provided just such a shock for many thrift institutions and some commercial banks.

Matters were made worse when the regulators did not require these institutions to be reorganized and recapitalized as soon as their economic worth was depleted. As a result, the institutions' capital accounts became negative.

In effect, the banks supplemented their private capital with public capital and taxpayers implicitly became shareholders with unlimited liability. And, at least, in the case of the savings and loan associations the taxpayers had been called upon to pay for the losses. The losses can be returned to the private sector by significantly increasing capital ratios and insured depository institutions. Losses at the Continental Illinois Bank were less than 5 cents on the dollar, and at the large Texas banks about 10 cents on the dollar.

If we assume that these banks had a 5 percent private capital ratios, then capital ratios of at least 15 percent would likely have prevented any failure of these banks if the regulators had been alert. And this does not even assume that the banks would have been motivated to reduce their risk exposure, as they most likely would have, because they had more of their own funds at stake.

Would such capital levels be too high and too costly? No. Nonfinancial firms average capital ratios of near 50 percent and the firms have been criticized recently for creeping too close to the edge. The major cost of increased bank capital now is the tax disadvantage of dividend payments on equity.

This cost can be reduced by permitting debt that is subordinated to the deposit insurance agency to be included in capital. Such subordinated debt is effectively equivalent to explicitly uninsured time deposits. By permitting subordinated debt, U.S. banks also would not be put at a competitive disadvantage with banks in other countries.

Whatever the capital level established, to be effective early intervention must include a number of features.

First, the institution must be reorganized and recapitalized before it's net worth becomes zero.

Second, to better focus the supervisory process, a series of capital asset tranches should be established. As an institution declines through these tranches, the regulatory sanctions would be progressively increased. These sanctions would include reduced powers, restricted interaffiliate fund transfers, increased reporting and supervision, reduced or suspended divided payments and suspended interest payments on the subordinated debt.

The sanctions would not only become progressively more restrictive as the institution's capital deteriorates, but also progressively more mandatory. When, despite these sanctions, an institution breaches the last tranche, which is set at a low but positive capital level, the regulators must immediately reorganize and recapitalize it.

First preference to provide the necessary capital to recapitalize the institution back to the regular no supervisory problem level would be given to the current shareholders. If the current shareholders prefer to walk away from the institution, the regulators can sell, merge or liquidate it.

If the institution were reorganized in time before its economic net worth is depleted, no losses will be borne by uninsured depositors or the deposit insurance agency. Losses to these groups would occur only from fraud, exceptionally abrupt declines in the prices of many financial assets concurrently or inadequate monitoring.

This scheme has many important advantages:

No. 1, there would be minimum losses to uninsured depositors and the deposit insurance agency.

No. 2, because losses would be minimized, deposit insurance premiums could be reduced substantially.

No. 3, also because losses would be minimum, deposit insurance becomes effectively redundant and is maintained only to cover cases of fraud and inadequate monitoring.

No. 4, because uninsured depositors are aware that losses will be minimized, the incentive to run is greatly reduced. Thus, the good aspects of Federal deposit insurance in preventing systemic runs is preserved.

No. 5, unless the demand for banking services is insufficient, the near insolvent banking facility is likely to maintain its franchise value and remain in existence under new management.

No. 6, a long and clear paper trail of regulatory warnings will be established as an institution declines through the tranches that will reduce the judicial uncertainty if the reorganization were challenged in the courts.

It is sometimes argued that an early intervention scheme involves confiscation or expropriation of private capital. This is untrue. If the shareholders prefer not to recapitalize their institution when it breaches the reorganization tranche, they will receive the net proceeds from the subsequent sale or liquidation. Moreover, the plan may be made voluntary in return for deposit insurance.

Much of the banking industry itself has recently rejected a hundred percent protection. In recent years to reduce both their losses and the need to impose losses on uninsured depositors, the regulators have slowly been intervening earlier at troubled institutions as the high costs of delay have become evident. But they are still not intervening early enough and still not requiring sufficient capital. Moreover, when the current crisis eases, they may be tempted to slide back to their former ways.

In recent days both Federal Reserve Chairman Alan Greenspan, and Federal Reserve Bank of New York, President Gerald Corrigan, have indicated their support for early intervention. But to make this approach effective, Congress must insist that any plan adopted explicitly include both performance tranches and mandatory recapitalization before a bank's capital is fully depleted.

Thank you.

[The complete prepared statement of George G. Kaufman follows:]

5/10/90

DEPOSIT INSURANCE REFORM

Statement by
George G. Kaufman
John F. Smith Professor of Finance and Economics
Loyola University of Chicago and
Co-Chair, Shadow Financial Regulatory Committee

before the
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Many of the current problems in the commercial banking and thrift industries and much of the cost of these problems are attributable to flaws in the design of the existing federal deposit insurance structure. As has been often and well documented, the existing structure encourages risk taking by both insured institutions and the insurance agencies. Insured institutions are encouraged to take greater risk because they do not pay insurance premiums that are tied to the degree of their risk exposure and are able to operate with substantially lower levels of private capital, indeed at times with no or negative capital. The insurance agencies and regulators are encouraged to take greater risk because they are not required to reorganize and recapitalize insolvent institutions in a timely fashion. As a result, the institutions are permitted to continue to operate in the hopes that they will either get lucky and regain their solvency or will not explode before being passed on to the next shift of regulators. In either case, the regulators protect their reputations by minimizing the number of official bank failures on their watch.

Because federal deposit insurance prevents deposit outflows from insolvent institutions, the regulators are able to put into play a Ponzi scheme in which deposit inflows are used to pay both interest on older deposits and operating expenses rather than used to support earning assets. As a result, liquidity does not become a problem for these banks. Before deposit insurance, deposit outflows would produce a liquidity problem that generally did not permit them to remain open.

The problems with the existing deposit insurance structure have been well known both in recent years and, equally importantly, sixty years ago when it was being debated in Congress. Unfortunately, from its adoption in 1933 to the early 1980s, the low rate of bank failures lulled us into forgetting the potential problems. It took the S&L debacle to jolt us back to reexamining the structure and hopefully correcting it now before another disaster hits. You have asked me to discuss six issues related to proposed cures.

1. **Should Congress strengthen the regulators' authority to carry out early intervention - i.e., to reorganize a troubled depository institution before it becomes insolvent? If so, how should early intervention operate?**

Early intervention and capital maintenance is my personal, and the Shadow Financial Regulatory Committee's, preferred solution. It deals directly with the two most costly features of the existing deposit insurance structure - - too little private capital in banking and the potential for continued operation when banks are insolvent - -and would impose the least cost on either the banking system or the taxpayers. It combines the best feature of the pre- FDIC structure - - market discipline - - with the best feature of the post-FDIC structure - - protection against a systemic currency run on the banking system as a whole. Because of my strong preference for this solution, I will spend a little more time on this option than on others.

A bank's capital absorbs losses up to the amount of the capital and protects depositors or the deposit insurance agency against those losses. Only when losses exceed the amount of capital will they be borne by depositors or the deposit insurance agency. Before the FDIC, all depositors had all their deposits at risk and demanded that their banks hold sufficient capital to cushion the shocks they were likely to encounter. Thus, in the early part of this century, bank capital ratios were near 20 percent. In addition, shareholders at all national banks and some state banks were personally liable for an additional amount up to the par value of their shares. As a result, contrary to current popular belief, bank failures were relatively infrequent until the 1920s. Indeed, from 1875 through 1920 the bank failure rate was lower than the nonbank failure rate. Moreover, losses to depositors at failed banks averaged less than 0.2 percent of total bank deposits per year and remained below 1 percent, even in crisis years.

The introduction of federal deposit insurance reduced depositor concern about the safety of their funds and permitted banks to reduce their private capital ratios sharply to near 6 percent. It does not take much of a shock to wipe-out 6 percent of a bank's assets. Unfortunately, the increased instability in macroeconomic performance in recent years coupled with fraud, managerial and regulatory inexperience with new powers, and inadequate regulatory monitoring and supervision provided just such a shock for many thrift institutions and some commercial banks. Matters were made worse when the regulators did not require these institutions to be reorganized and recapitalized as soon as their economic net worth was depleted. As a result, the institutions' capital accounts became negative. In effect, the banks supplemented their private capital with public capital and taxpayers implicitly became shareholders with unlimited liability. And, at least, in the case of the savings and loan associations, they have been called upon to pay for the losses. Of course if the banks win, the earnings and dividends go only to the private shareholders. It is time to return the losses to the private sector!

This can be achieved by significantly increasing capital ratios at insured depository institutions. Losses at the Continental Illinois Bank were less than 5 cents on the dollar and at the large Texas banks, about 10 cents on the dollar. If we assume that these banks at one time had 5 percent private capital ratios, then capital ratios of 15 percent would likely have prevented any failures of these banks if the regulators had been alert. And this does not even assume that the banks would have been motivated to reduce their risk exposure, as they most likely would have, because they had more of their own funds at stake. The FDIC reports that losses on all its insolvent banks average about 30 cents on the dollar recently and probably all but the very worst thrift failures were of like magnitude. Thus, a 35 percent capital ratio would have prevented the very large majority of all losses under the same assumptions. Is this too much capital? Nonfinancial firms average capital ratios of near 50 percent and the firms have been criticized for creeping too close to the edge. The major cost of increased bank capital now is the tax disadvantage of dividends payments on equity. This cost can be reduced by permitting debt that is subordinated to the deposit insurance agency to be included in capital. Such subordinated debt is effectively equivalent to explicitly uninsured time deposits.

The recently adopted risked-based capital standards will not be very helpful in protecting bank safety. A recent study by the American Banker (April 19, 1990) reported that at year-end 1989, even at today's vastly insufficient capital ratios, only 4 percent of the 92 of the 100 bank holding companies surveyed failed to meet the 1992 standard of 4 percent tier 1 capital and 8 percent total capital.

Whatever the capital level established, to be effective early intervention must include a number of features. First, the institution must be reorganized and recapitalized before its net worth becomes zero. Second, to better focus the supervisory process, a series of capital-asset tranches should be established. As an institution declines through these tranches, the regulatory sanctions would be progressively increased. These sanctions would include reduced powers, restricted interaffiliate fund transfers, increased reporting and supervision, reduced or suspended dividend payments and suspended interest payments on the subordinated debt. The sanctions would not only become progressively more restrictive as the institution's performance and capital deteriorates, but also progressively more mandatory. When, despite these sanctions, an institution breaches the last tranche, which is set at a low but positive capital level, the regulators must immediately reorganize and recapitalize it.

First preference to provide the necessary capital would be given to the current shareholders in accord with the business plan that management was required to file at some earlier tranche for recapitalizing the institution back to the regular, no supervisory problem level. If the current shareholders prefer to walk away from the institution, the regulators can sell, merge, or liquidate it. To do so for large banks, they can use the bridge bank powers that they possess, if necessary. But speedy reprivatization must follow. If the institution were reorganized in time before its economic net worth is depleted, no losses will be borne by depositors or the deposit insurance agency. Losses to these groups would occur only from fraud, exceptionally abrupt declines in the prices of many financial assets concurrently, or inadequate monitoring.

This scheme has many important advantages.

1. There would be minimum losses to uninsured depositors and the deposit insurance agency.

2. Because losses would be minimized, deposit insurance premiums could be reduced substantially.

3. Also, because losses would be minimum, deposit insurance becomes effectively redundant and is maintained only to cover cases of fraud and inadequate monitoring.

4. Because uninsured depositors are aware that losses will be minimized, the incentive to run is greatly reduced. Thus, the good aspect of federal deposit insurance in preventing systemic runs is preserved.

5. Unless the demand for banking services is insufficient, the near-insolvent banking facility is likely to maintain its franchise value and remain in existence under new management.

6. A long and clear paper trail of regulatory warnings will be established as an institution declines through the tranches that will reduce judicial uncertainty if the reorganization were challenged in the courts.

It is sometimes argued that an early intervention scheme involves confiscation or expropriation of private capital. This is untrue. If the shareholders prefer not to recapitalize their institution when it breaches the reorganization tranche, they will receive the net proceeds from the subsequent sale or liquidation. Moreover, the plan may be made voluntarily in return for deposit insurance. I attach a more complete description of the proposal as drafted by the Shadow Financial Regulatory Committee in its policy statement no. 41, dated February 13, 1989. (See also Brookings Institution, Blueprint For Restructuring America's Financial Institutions: Report of a Task Force, Washington, D.C., 1989).

What needs to be done to implement this proposal? Most importantly, it is necessary to design the legal aspects of the reorganization provision so that the reorganization and recapitalization may be achieved swiftly and efficiently. Although much can be learned from the bankruptcy code, this process is too time consuming and inefficient to be adopted in its entirety for banking. A new code should be drafted.

2. **Should depository institutions be required to use market-value accounting? What specific steps towards market-value accounting are feasible?**

Federally insured depository institutions should be required to report the values of their on- and off-balance sheet accounts to the deposit insurance agency on a market value basis. Only in this way can the insurer have an accurate picture of its liability. Public reports could be either on a book or market value basis, although I would suspect that they will be on both bases shortly after market value reporting is required. Most financial analysts now convert book values into market values for their own use. In addition, more and more institutions are making these calculations for managerial purposes.

Market value accounting is not easy and not likely to be completely accurate. But it is not exceptionally difficult relative to other challenges in our modern and complex world and is far more accurate than book value accounting. A number of studies of the savings and loan debacle indicate clearly that book value net worth gave an incorrect and often misleading measure of an institution's financial strength and contributed to the regulatory agencies' delayed response.

I am not an accountant and cannot spell out all the steps toward market value accounting that are feasible now. But I know that a number of large institutions are using market value accounting for internal purposes to give them a better handle on their own financial condition. A publication I co-authored with Professor George Benston of Emory University, who is a CPA, entitled Risk and Solvency Regulation of Depository Institutions (Salomon Brothers Center, New York University, 1988) spells out a number of steps for achieving market value reporting for banks. Lawrence White, former member of the Federal Home Loan Bank Board has also discussed ways of implementing market value accounting in a series of articles, including one in the Board's January 1988 Outlook as has David Glenn, executive vice-president of the Federal Home Loan Mortgage Corporation (Fredie Mac) in Secondary Mortgage Markets, Summer 1988. In addition, two articles on how to do market value accounting are included in two books that I am editing. An article by George Benston will appear in Restructuring the American Financial System (Kluwer, 1990) and an article by David Mengle of the Federal Reserve Bank of Richmond will appear in Research in Financial Services (JAI Press, 1991). Both articles would be helpful to practitioners. But more work needs to be done both on developing appropriate techniques and, more importantly, in familiarizing practitioners with the techniques. Market value accounting is, however, not a prerequisite for early intervention, although it would increase its effectiveness.

It is unfortunate that the bank regulatory agencies, who have the most to gain from market value accounting in terms of preventing large losses, have for the most part been slow in supporting the concept and its application. It would be very helpful if the regulatory agencies would now turn their substantial intellectual and technical resources to improving the procedures both for obtaining market values and for implementation. They could make major contributions.

3. **Should a company that controls a bank or thrift be free to let the institution fail, without making any effort to assist it? If not, in what ways should the parent company be obligated to assist the subsidiary.**

The so-called "source of strength" policy discriminates in two important ways. One, it concerns only parent corporations of banks, not parent individuals or partnerships. Two, it concerns only bank subsidiaries. Parent corporations are free to walk away from their failing nonbank subsidiaries if they wish. Some do and some do not, depending on individual circumstances. It makes little sense to single out corporations and banks for special treatment in order to avoid making the necessary fundamental changes in deposit insurance. It would be fairer to extend the source of strength policy to all bank owners. This would resemble the double liability provision of most bank stock in the pre-1933 period. If the capital maintenance and early intervention proposal described above is adopted either for the bank or the bank holding company, this issue becomes mute. If banks are reorganized before their capital is depleted, no assistance from their parents is required. Of course, if a holding company wants to maintain its ownership, it would have to recapitalize the bank to a safe level.

4. **Should deposit insurance - - currently $100,000 for depositors, with no coinsurance and deductible - - be reduced? If so, how? Should corporate depositors be treated differently from individuals? What, if anything, should be the role of private deposit insurance?**

Whatever the initial reasons for adopting federal deposit insurance in 1933 - - and there were many - -, the only valid reason today is to protect the aggregate money supply by preventing a run from the banking system as a whole into currency. Because large depositors cannot operate using currency, only small depositors need be of concern for public policy. Thus, in terms of the economics, deposit coverage can be reduced substantially below $100,000 and even below $40,000. Small depositors can protect their funds completely in Treasury securities or money-market funds (narrow banks). Nor is it necessary to distinguish between corporate and individual depositors. Private insurance would not be efficient for the first X dollars of coverage, as private insurance companies can and do default and this minimum amount should be absolutely default-free. But private insurance is appropriate for supplementary insurance above the basic amount.

Again, by minimizing bank failures and losses to depositors, the early intervention proposal effectively makes deposit insurance redundant. Thus, insurance may be maintained because it would then be nearly without cost and the difficult political decision to reduce coverage can be avoided.

5. **Should Congress adopt (or authorize the FDIC to adopt) risk-based deposit insurance premiums? If so, how should premiums be determined?**

Risk-based insurance premiums were once the favorite of most banking experts. But many, including the Shadow Financial Regulatory Committee, have now backed away from it. Risk-based premiums are flawed both in theory and in practice. In theory, the loss to the bank, depositors, and deposit insurance agency is not so much a function of the bank's risk exposure as it is of the failure of the regulators to reorganize the institution promptly before its economic net worth turns negative. As discussed above, any delay is primarily a function of monitoring and will-power by the regulators. Bank risk and monitoring may be related, but they are unlikely to be perfectly correlated. Monitoring-based premiums would be more logical, but still inferior to timely regulatory intervention.

In practice, risk is difficult to measure accurately. Important lessons may be learned from the recently introduced risk-based capital scheme. Well accepted finance theory informs us that risk is a function not of individual securities or accounts but of the overall portfolio. A number of individually risky activities may through diversification produce a portfolio with little risk. Yet, the risk-based capital standards use individual asset categories. Moreover, the riskiness of an activity, and thereby the weight assigned to it, can be measured only by observing changes in its price or market value, not in its book price. Yet, the risk-based capital standards use book values. Indeed, if risk classifications are based on nonmarket criteria, they lend themselves to government credit allocation. Why are residential mortgages in the risk-based standards only one-half as risky as short-term commercial loans in the risk-based capital standards and five-times as risky as long-term Treasury securities? Why is ship-building a riskless activity in the United Kingdom? Moreover, as any banker knows, for banks, risk is measured by the net effect of both sides of the balance sheet combined, not the asset or the liability side separately.

Thus, the appropriate risk-capital level for each bank should be left to the market place to determine as it is in almost every other industry and was in banking before 1933. With appropriate capital maintenance and early intervention, it can be so again.

6. Is any depository institution really too big to fail? How should regulators deal with troubled institutions?

No, and since the failure of the First Republic Bank (Texas), we do fail banks. What we do not do is share the losses of failed banks between the deposit insurance agency and the uninsured depositors. That is a mistake that is too costly to continue. As I argue in my paper "Are Some Banks Too Large To Fail: Myth and Reality" (a copy of which is attached), the current policy, as well as the earlier policy of too large to fail, are based on the regulators' fears of contagion from large bank failures to other, healthy banks and possibly the macroeconomy and of no alternative suppliers of money and credit. Both fears are unwarranted today.

With a credible federal deposit insurance system and an alert Federal Reserve that will inject reserves lost to the banking system from a run to currency, the probabilities of nationwide contagion or domino effects from bank failures effectively are zero. Indeed, to the extent we encountered bank runs in recent years, even at the height of the Texas S&L crisis, it was not from bad banks to good banks for safety but from good banks to bad banks for higher returns with insured safety. The problem bankers voice today is not of a shortage of money and credit in a community, but of too much competition from too many suppliers of money-like and credit-like instruments by thrift institutions, money market funds, finance companies, insurance companies, mutual funds, and even nonfinancial firms, such as Sears and General Electric.

The changes in the so-called "too large to fail" (TLTF) policy since the rescue of the Continental Illinois Bank in 1984 have been accompanied not by a disastrous bang, as was widely predicted, but by a hardly noticeable whimper. In 1984, the FDIC made whole all creditors of the Continental Bank and its parent holding company and did not fail the bank legally. Dire predictions were made of the consequences had the FDIC not done so. What large creditor would even lend to a bank or bank holding company again? In 1986, the FDIC did not make whole creditors of the insolvent First Oklahoma's parent holding company. But creditors did not run from other bank holding companies. In 1988, the FDIC caused the First Republic Bank (Texas) to be failed legally. No run on other banks or the banking system followed. In 1989, the FDIC did not make whole the otherwise solvent affiliated banks in MCorp who had correspondent balances or fed funds with their insolvent bank affiliates. Again, the world did not end or even make much noise, except for a legal claim that all creditors were not treated equally. All that remains is to do just that - - share all losses at insolvent institutions proportionately among all uninsured depositors and creditors.

It is ironic that primarily only the regulators oppose such a scheme. The country's largest banks belonging to the New York Clearing House Association, which may be expected to be most directly affected by a change in TLTF, have publicly announced their support for prorata sharing of losses. The American Bankers Association has recently supported loss sharing and has argued that:

> The single most important goal of deposit insurance reform should be to require investors in uninsured deposits to share in the risk of failure of institutions to which they commit their funds. [Federal Deposit Insurance: A Program For Reform, 1990, p. 7].

Many former regulators, including William Isaac, who was chairman of the FDIC at the time of the Continental Illinois rescue, have recanted on their 100 percent support. Congress has improved the regulators' options in dealing with insolvent large institutions through the means of bridge banks. Thus, the mechanism is in place. All that is needed is the political will and courage. Because of the reluctance to impose losses on uninsured depositors and creditors at insolvent banks, requiring such haircuts is likely to lead the regulators to move to early intervention in order to minimize if not eliminate such losses.

In closing, deposit insurance reform is both needed now and, as

I proposed above, possible now through early regulatory intervention. Any costs involved in improving the design of the structure, and there will be some, are dwarfed by the accumulated past costs and potential future costs of delay.

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ARE SOME BANKS TOO LARGE TO FAIL?
MYTH AND REALITY

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That the world, or at least banking, as we know it today will end if we permit large banks to fail is one of the great popular beliefs in banking and a current favorite of many bank regulators. This belief may be called the "too large to fail" or TLTF myth. Similar myths also exist in nonbanking, for example, in industry with Chrysler and in local government with New York City. Moreover, these myths are not limited to the United States.

TLTF is frequently used by bank regulators to avoid taking actions that could put them in conflict with powerful parties who would experience large dollar losses, such as uninsured depositors or other bank creditors, management, owners, and even large borrowers. In addition, regulators frequently believe that such actions would be an admission of failure not only of the bank but also of their own agency, which is charged with bank safety and evaluated by many on its ability to achieve this condition. In using TLTF, the regulators play on the widespread public fears of using TLTF, the regulators play on the widespread public fears of the contagiousness of bank failures, that is, on fears that bank failures may ignite a domino or chain reaction that would tumble other "healthy" banks nationwide, other financial institutions, and possibly even nonfinancial institutions and the aggregate macroeconomy.

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The failure of large banks is viewed particularly likely to cause spillover because of:

1. The large number of depositors;
2. The large number and dollar amounts of corresponding balances from other banks;
3. The presence of foreign deposits, and
4. The important role such banks play in the payments system.

The economic justification for TLTF has been clearly stated by bank regulators. At the time of the Continental Illinois National Bank crisis in 1984, Comptroller of the Currency Todd Conover testified that if:

> Continental had failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis the dimensions of which were difficult to imagine. None of us wanted to find out. (Conover, 1984, pp. 287-88).

In 1986, Irvine Sprague, who was a director of the FDIC at the time of the Continental Illinois rescue, wrote in his book Bailout:

> The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become.... Various scenarios were laid

> out, and they all signaled doomsday. (Sprague, 1986, p. 155).

More recently, FDIC Chairman William Seidman stated that:

> The bottom line [re TLTF]... is that nobody really knows what might happen if a major bank were allowed to default, and the opportunity to find out is not one likely to be appealing to those in authority or to the public. (Seidman, 1988A, p. 9).[1]

These statements suggest that the regulators did not know what would happen if a large bank fails and/or defaults; that they have done little if anything since the Continental crisis in 1984 to find out; and that they have acted in a way that reduced primarily their own risk exposure and that of their agency.

Because it may be too severe a standard to expect bank regulators to have a better understanding of the economics of the banking system than others, one might have been able to excuse this attitude in 1984, when nearly everyone, including most academics, subscribed to the "Chicken Little" theory of bank failures. But research since then has clearly shown that, although theoretically possible, nationwide contagion is highly unlikely, particularly in today's environment with credible federal deposit insurance and a Federal Reserve that is wiser than in the 1930's (Benston et al., 1986). Because the federal government guarantees the par value of their deposits, deposit insurance discourages smaller depositors from starting a flight from bank deposits to currency. Even if deposit insurance does not discourage such a flight, the Fed can intervene to offset the resulting decline in aggregate bank reserves and money supply. Because it is impractical to conduct their financial operations with currency, larger depositors do not flee from bank deposits to currency but search for safe banks.

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[1] Basically the same statement was made in Seidman, 1990A.

But despite this evidence, the regulatory agencies' policies towards TLTF have changed only moderately since 1984. It is almost as if they do not want to hear the recently developed "good" news. In the meantime, the cost of their policies of permitting economically insolvent large institutions to continue in operation are plainly evident:

1. Private market discipline is weakened and greater risk taking by other banks is encouraged when they learn that the penalties for failure are not so severe. This has been a major contributor to the large dollar size of the current FSLIC crisis.
2. Smaller banks are discriminated against and put at a competitive disadvantage.

Bank Runs

Underlying most economic TLTF arguments is the fear of bank runs. Runs are viewed as the germs that spread contagion. Bank runs have two effects: one, on the individual banks experiencing the run themselves; and two, a potential effect on other banks and beyond. In a world with less than 100 percent deposit insurance, runs develop when a large number of depositors believe, rightly or wrongly, that their bank is economically insolvent and cannot repay all noninsured deposits in full and on time. These depositors subscribe to the reasonable hypothesis that it is better to be safe than sorry.

For an individual bank, a run causes liquidity problems from hurried "fire-sale" losses. But theory and evidence both show that if the bank was solvent at the time the run started - - the depositors were wrong - - the run will not bring the bank down. That is, the liquidity problem will not expand into a solvency problem. Solvent banks generally experience little difficulty in obtaining sufficient liquidity through liquid asset sales or borrowing from other banks to meet deposit outflows (Kaufman, 1986). If the bank was economically insolvent to begin with -- the depositors were right - - the run will intensify the liquidity problem, as fire-sale losses are likely to be larger. However, the run was not the initial cause of the bank's problems. If banks were appropriately reorganized and recapitalized on a timely basis when they first became insolvent, depositors would know they would not suffer losses and the run would have been unlikely. This conclusion is not new; it was reached in a study for the American Bankers Association in 1929 and was recently reconfirmed by a survey by Anna Schwartz for the American Enterprise Institute (Kaufman, 1986 and Schwartz, 1988).

The implications of a run on an individual bank for other banks depend on what the running depositors do. They have three options:

1. If the depositors perceive other banks in their market areas to be safe, they will shift their funds to those banks. This represents a direct deposit. (This would include deposit transfers to overseas banks. In such shifts, the foreign bank becomes the owner of the deposit at the domestic bank).

2. If the running depositors do not perceive other safe banks in their market areas, they are likely to purchase safe nonbank securities, such as Treasury securities. This represents a flight to quality. Now the question becomes, what do the sellers of the securities do with the proceeds? It is likely that the sellers perceive some safe banks in their market areas, because otherwise they would have been unlikely to sell the securities. This scenario represents an indirect redeposit.

3. If neither the running depositors nor the sellers of the Treasury securities perceive any bank in the country to be safe, they will not redeposit the funds in other banks. Rather, they will hold currency outside the banks. This represents a flight to currency.

In both of the first two scenarios, there is little serious economic damage. Reserves and deposits are not lost to the banking system as a whole, but merely redistributed within the system. There is no decline in the money supply, nor are there universal liquidity problems. The liquidity strains of those banks losing deposits are more or less offset by the liquidity surpluses of those banks gaining deposits. Some depositor and borrower dislocation may occur and uncertainty will increase. In addition, in the case of a flight to foreign currencies and banks overseas, a restructuring of exchange rates will occur as prices on safe Treasury securities are bid up relative to those on risky bank deposits. The last two scenarios may adversely affect the terms of trade, dampen private investment activity, and cause abrupt changes in relative asset and goods prices. But, as there is no collapse of the money supply, nationwide bank insolvencies or a significant downturn in national business activity, which are the primary underlying fears from a bank run and the primary justification for special protection for large banks, will not occur. Runs on banks may spillover to banks that the public views as being beset by the same problems and ignite regional contagion, e.g., in Texas in the 1980s. But this contagion is no different than that which occurs when any visible business firm fails or with any important frightening event, such as an act of terrorism or a "Tylenol" scare.

The third type of bank run lies behind the public fear of bank runs and has the most far-reaching effect. Because currency can only reach the public from the banks, a currency outflow will reduce bank reserves in the aggregate and thus also the money supply. Under fractional reserve banking, a loss of reserves ignites a multiple contraction process that affects healthy as well as insolvent banks. The attempts of all banks simultaneously to meet their deposit outflows increases the amount of securities for sale, fire-sale losses, and the likelihood of the banks' liquidity problems expanding into solvency problems. The feared spill-over effect becomes a reality. The run on an individual bank is transformed into a run on the banking system as a whole and may topple nonfinancial firms and impact the macroeconomy adversely. It is this scenario that makes bank failures uniquely different from the failures of other business firms.

But U.S. history shows that a flight to currency is rare (Benston, et al., 1986, Chapt. 2). Bank failures and bank runs have not been very closely correlated. Although bank failure have been relatively frequent throughout much of pre-1929 U.S. history, runs on individual banks were not. Indeed, runs on individual banks were negligible even during the prolonged period of frequent bank failures in the 1920s, when bank failures averaged more than 600 annually. The Comptroller of the Currency attributed few of the failures of national banks in this period to runs (Schwartz, 1988, pp. 34, 55-56). In part, the lack of runs in this period may be attributed both to the relatively small size of the failed banks and to the maintenance of reserves and money supply by the Federal Reserve (Friedman and Schwartz, 1971, pp. 353-357).

Almost all runs have led to either direct or indirect redeposits. Before the establishment of the Federal Reserve in 1913, private markets operated reasonably successfully to reduce the probably of a type-one or type-two bank run from developing into a type-three run. However, the cost was not zero. At times, the process involved temporary suspensions of convertibility and the issuance of "private" money in the form of clearing house certificates (Gorton, 1985 and Timberlake, 1984). But this cost was substantially lower than that of a type-three run or, in retrospect, lower than the policies used by the regulatory agencies in recent years to prevent such a situation. (The SLA crises in Ohio and Maryland in the early 1980s were the worst of all scenarios. There was no private market at work and no credible government insurance, Kane, 1988 and 1989).

Only in 1893 and 1929-33, were significant flights to currency and nationwide contagion likely to have occurred. But even in these periods it is not clear that the bank runs were the cause of the concurrent depressions, rather than vice-versa. Indeed, recent evidence suggests that the runs were as likely to have been symptoms of the problems in the macroeconomy as originators of these problems (Gorton, 1988 and Cagan, 1965). For example, Canada experienced approximately the same percent declines in aggregate economic activity between 1929 and 1933 as did the United States - - GNP declined by about 40 percent, prices by some 25 percent, and M1 by some 30 percent. But there was no banking crisis in Canada. There were no runs either on individual banks or on the banking system. The currency to money ratio increased only moderately, compared to the U.S., where it more then doubled. Thus, in Canada, bank runs could not have been a contributor to the macroeconomic difficulties.

The recent experience of savings and loan associations in Texas also points to the high unlikelihood of national contagion and of spill-over beyond institutions perceived to be in the same boat. Texas SLAs, as well as the industry as a whole, experienced an outflow of deposits from mid-1988 through mid-1989. In large measure, the outflows reflected the sharp rise in short-term market interest rates, including those offered by money market funds. Most SLAs did not match these rates on their deposits and voluntarily permitted the consequent disintermediation. But economically, such disintermediation does not represent a run.

At the same time, increasing publicity about FSLIC's increasing problem and the increasing insolvency of Texas SLAs increased uncertainty among some depositors and some undoubtedly withdrew their deposits. But these funds were redeposited at perceived solvent SLAs in other states, money market funds, or FDIC insured commercial banks. They represented type-one runs--direct redeposits. There has been no evidence whatsoever that these depositors held their withdrawals in currency. Because of the paucity of information about the financial condition of financial institutions and the natural tendency in times of uncertainty to avoid contact with activities that may be similarly tainted (e.g., all airlines are effected by a major skyjacking and all bottles of over-the-counter drugs are suspect after a container poisoning scare), depositors may have avoided redepositing at healthy SLAs in Texas. More recently, the problems at large commercial banks in Texas, e.g., First Republic and MCorp. resulted in flights to large banks elsewhere. This behavior represented a flight to safety, but not a flight to currency. Although not good for healthy SLAs and banks in the "contaminated" area, such a flight does not topple healthy banks in other areas or destabilize the financial system as a whole.

Yet, in this instance, regulators have failed to distinguish both between disintermediation and runs and between contagious and noncontagious runs. Instead, they publicized the Texas outflows as contagious runs, at least partially, to build public support for the administration's SLA rescue proposal. For example, Chairman Seidman has argued that:

> While depositor discipline may theoretically be desirable, placing depositors at greater risk has not proven to be useful in practice. The problem is that depositor discipline sometimes works too well - - taking the form of bank runs, which pose a threat to the stability of the financial system (Seidman, 1988 B, p. 9).[2]

Besides reflecting an implicit reversal from an earlier FDIC position that market discipline was relatively ineffective, Seidman provides no evidence that runs resulting from private market discipline pose any threat to financial stability. Indeed, Seidman overlooks the beneficial aspects of the threat of bank runs as a strong deterrent to excessive risk taking by banks. History suggests that the threat of runs is more likely to strengthen rather than to weaken the long-run stability of the financial system (Kaufman, 1988B).

Indeed, it is not private market discipline that appears to cause the worst runs, but federal deposit insurance. No bank or association has lost sufficient deposits in recent years to shrink from, say, $2 billion to $50 million in a few months. But a number of SLAs have grown by this magnitude in a not much longer time span. Federal deposit insurance has caused more frequent and greater runs to bad banks, which offered higher deposit rates, than private market discipline has caused runs from bad banks (Duke, 1989).

Moreover, even before federal deposit insurance, banking in annual bank failure rate was lower than the failure rate among nonbank firms, although the variance was greater. In addition, losses to depositors at failed banks were averaged less than 0.2 percent of total bank deposits, annually. Moreover, even losses to depositors at failed banks averaged less than losses suffered by bond holders in defaults of nonfinancial firms (Kaufman, 1986). As noted earlier, bank runs did not generally lead to bank failures and bank failures did not generally lead to bank runs. Banks tended to fail when the economy they served weakened. In this regard they are no different from grocery stores, automobile dealerships, movie theaters, or any other business firms.

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[2]. See also the account of the FDIC's takeover of the Broadview Savings Bank (Ohio) in Day, 1989.

Resolving Large Bank Failures

Primarily because few large banks appeared threatened with failure before the Continental Illinois National Bank crisis in 1984, the regulators gave considerably more thought to procedures for resolving small- and medium-size bank failures than large bank failures. (The United States National Bank of San Diego and the Franklin National Bank in the mid-1970s were the only large bank exceptions and neither were money center banks). From 1983 through the Continental crisis in mid-1984, the FDIC experimented with imposing pro-rata losses or "haircuts", on uninsured depositors at insolvent banks. This was done both through modified payoffs, in which the insured deposits and the non-haircut portion of the uninsured deposits are assumed by ar acquiring bank in a purchase and assumption (P&A) transaction, and through liquidation, such as in the case of the Penn Square (Oklahoma) bank. But the FDIC backed away from these policies in the Continental crisis because of fear and uncertainty from at least three sources:

1. Large bank size
    a. Large potential dollar losses
    b. Long resolution time
2. Large number and dollar volume of interbank balances with potential large losses to a large number of banks. Over 2,000 banks had correspondent balances and/or Fed funds loans with the Continental and 200 of these had balances that were greater than one-half of their net worth.
3. Substantial foreign deposits.

But none of these were legitimate fears.

1. Large bank size
    a. The Continental Bank was not totaled. Depositor losses were estimated at the time to be about 2 to 3 cents on the dollar. Indeed, then-FDIC Chairman William Issac even denied that the bank was insolvent. Currently, losses are estimated to be near 4 cents per dollar.[2]
    b. The FDIC had authority to use longer resolution time under conservatorship and deposit insurance national bank provisions.
2. Even if the losses had been as high as 10 percent, twice the largest estimate, no correspondent bank would have suffered losses greater than its capital and only two would have suffered losses greater than 50 percent of their capital. (U.S. Congress, 1984, pp. 16-18 and Kaufman, 1985).

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[2] The Continental Bank estimates that the loss would have been about $1.5 billion on $40 billion of deposits (Fergerson, 1990).

3. Similar to deposit transfers by domestic depositors, transfers by foreign depositors even to overseas banks do not change either total reserves or deposits in the U.S. banking system. Unless the withdrawals are in currency, which is highly unlikely for large deposits the reserves are shifted among domestic banks, although foreign banks may now own some of the deposits at these banks. If the funds are transferred to overseas banks in local currencies, exchange rates are likely to be affected.

In other words, the bank regulatory agencies did not thoroughly think through the consequences of all available options.

In practice, TLTF is not the issue anymore. The FDIC has modified its large bank nonliquidation failure resolution policies three times since the Continental rescue to progressively increase the number of creditors whose funds are risk.[3]

1. In 1984, the FDIC followed three policies with respect to the Continental:
   a. TLTF - too large to fail legally, although the bank is economically insolvent,
   b. TLTILUBC - too large to impose losses on uninsured insolvent banks creditors and depositors; and
   c. TLTILBHCC - too large to impose losses on insolvent bank holding companies creditors.

In sum, this amounted to a policy of too large to fail legally and impose losses on all uninsured creditors, or TLTFLILAUC.

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[3] Few large insolvent banks, similar to any other large insolvent firm, are liquidated and depositors paid off. The FDIC will resort to such a policy only if it is unable to quantify the bank's assets and the contingencies are sufficiently undeterminable to make a sale too costly. Since 1934, the FDIC has liquidated only two reasonably large banks, the Penn Square Bank (Oklahoma) in 1982 and the Guardian Bank (New York) in 1989. Both banks had under $0.5 billion in deposits. Tax considerations played a part in the FDIC's decisions in some cases.

2. In 1986, the FDIC permitted the First Oklahoma Corporation to default on its debt when its subsidiary First National Bank of Oklahoma City became insolvent. However, it neither permitted the bank to fail legally nor imposed losses on uninsured depositors and creditors of the bank. A similar policy was followed in 1987 for the First City National Bank of Houston and First City Corporation. The remaining policy may be described as too large to fail legally and impose losses on all uninsured bank creditors, or TLTFLILAUBC.

3. In 1988, the FDIC both declared the First Republic National Bank of Dallas to have failed legally as well as being economically insolvent and imposed losses on creditors of its parent holding company, First Republic Corporation. The remaining policy was too large to impose losses on all uninsured bank creditors, or TLTILAUBC.

4. In 1989, the FDIC imposed pro-rata losses on fed funds sales and the uninsured portion of interbank deposits of solvent MCorp subsidiary banks at other insolvent MCorp (Texas) subsidiary banks. Indeed, these losses drove some of the former banks into insolvency. Because similar losses were not imposed on other uninsured creditors at these banks, the FDIC's action is being challenged in courts. Special authority for the FDIC to impose such haircuts on interbank deposits of affiliated banks was explicitly authorized in the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) of 1989.

Thus, only a policy of too large to impose losses on most uninsured bank creditors, or TLTILMUBC remains. Importantly, no spill-over or other adverse effects occurred when the other three safeguards were removed one at a time, despite predications of such consequences.

Resolution procedures for large-bank failures do differ from small-bank failures, but primarily because their large size makes them more complex and lengthens the time required to develop optimal solutions. In the Competitive Equality Banking Act of

1987, Congress specifically provided the FDIC with more time in which to resolve large bank failures and return them to the private sector by authorizing the establishment of FDIC operated "bridge" banks for up to two years, later extended to three years by FIRREA in 1989, if necessary. The FDIC can apply its market-tested modified payoff technology. The FDIC encountered no significant problems with it at smaller banks, and should not encounter any such problems at larger banks. At the close of business on the day the FDIC assumes control of the bank, it estimates the economic loss or negative net worth and pro-rates it among insured and noninsured deposits (FDIC, 1983 and Macey and Miller, 1988). A loss estimate has already been made by necessity when the FDIC decided to take control of the bank. The FDIC assumes the loss on insured deposits and charges the loss on uninsured deposits to the appropriate depositors. This haircut is deducted from the uninsured deposits. Overnight (or, more frequently, over a weekend), the bank is sold, merged, or rechartered as a bridge bank. At the opening of business the next day, insured depositors have full use of all their deposits and uninsured depositors have full use of the non-haircut portion of their deposits. There is no interruption in business.

Immediate estimates of the negative net worth of a bank and, therefore, of the loss allocated to uninsured depositors are likely to differ from the actual loss, which can only be determined much later. What if the FDIC's preliminary estimates are incorrect? In both its modified payoff and liquidation resolutions, the FDIC pays out additional funds through time to reimburse the uninsured depositors if its original estimate of loss was greater than the later determined actual loss and absorbs all additional losses if its original estimate turns out to have been too optimistic. The FDIC's recent treatment of the MCorp and later of Texas American (Dallas) intersubsidiary bank deposits appears to have followed this procedure.

To minimize possible disruption from a sudden change in ground rules, this process could be phased in over time, say, a maximum haircut of 1 percent in the first year of operation, 3 percent the second year, 5 percent the third year, and no limit the fourth and following years. Such a policy was floated in the mid-1980s by some officials of the American Bankers Association (Lamb, 1986). Interestingly enough, when first proposed, it was rejected most strongly by the bank regulators. More recently, the American Bankers Association has published a reform program that argues that:

> The single most important goal of deposit insurance reform should be to require investors in uninsured deposits to share in the risk of failure of the institutions to which they commit their funds (American Bankers Association, 1990, p 7).

The report rejects 100 percent deposit protection as unacceptable and recommends that market discipline be enhanced. When a bank's equity capital falls to zero, the bank should be declared insolvent, uninsured depositors and creditors be assessed a loss equal to the average loss the FDIC has experienced in recent years, and the bank be re-opened the next business day as part of another bank or as a bridge bank (American Bankers Association, 1990, pp. 15-17). Abandonment of TLTF was also recently recommended by the members of the New York Clearing House Association, who are among the country's very largest banks and the one most likely to be adversely affected (Horowitz, 1990). This suggests that TLTF is as much a political as an economic issue.

Resolution of large bank failures by modified payoff technology will significantly increase private market discipline by uninsured depositors and creditors. Contrary to the belief of Seidman and many other bank regulators, such discipline works well and in a stabilizing fashion by encouraging banks to increase their capital and reduce the risk exposure of their portfolios (Benston et al., 1986 and Kaufman, 1986). It did so before the FDIC and should operate even more efficiently now, because information about individual banks is quicker and cheaper to obtain than earlier. The threat of a run is a powerful force in inducing banks to err on the side of conservatism. Seidman appears to confuse the ex-ante incentives of banks under market-discipline and no-market discipline scenarios (Kaufman, 1988A and 1988B).

Under the first, bankers will have already acted to reduce the probability of a run on their banks by maintaining higher capital-to-asset ratios and incurring less risk exposure in their asset-liability portfolio mix. As discussed earlier, in this setting, runs are unlikely to topple banks. Under the second scenario, bankers will be less prepared as they have less at stake. In the absence of federal deposit insurance, runs are more likely to occur and bankers will be less able to prevent a bank failure when they do occur. This point has been recognized as far back as Walter Bageshot, more than 100 years ago (Humphrey, 1989). Any change in regimes that may increase the likelihood of runs in the short-run needs to be phased-in slowly to give bankers sufficient time both to revise their operating strategies and to achieve their new equilibrium positions.

Of course, the threat of runs on and failures of all banks can be reduced further by adopting a program for more timely and mandatory regulatory intervention and recapitalization before a bank's economic net worth turns negative. This has been proposed by the author and George Benston, the Shadow Financial Regulatory Committee, and, in measure and without the mandatory provisions, recently adopted by the Federal Home Loan Bank Board, shortly before its demise, and by the Comptroller of the Currency (Federal Home Loan Bank Board, 1988; Benston and Kaufman, 1988; and the Shadow Financial Regulatory Committee, 1989).[4]

In sum, a cost-benefit analysis of "too large to fail", even in its current less extreme form of "too large to impose losses on most uninsured bank creditors," clearly indicates that the cost of perpetuating the myth that this policy is necessary to preserve the world as we know it today is too great. This truth was recently recognized by none less than William Issac, who as Chairman of the FDIC during the Continental Illinois Bank crisis led the forces in favor of making everyone whole and defended his actions vigorously for many years. Recently, however, he recanted and admitted that:

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[4] In April 1989, the Federal Home Loan Bank Board assumed control of three associations that were solvent by regulatory accounting principles (RAP) but not by generally accepted accounting principles (GAAP) - - Gibraltar Savings of Beverly Hills, CA; Gibraltar Savings of Bellevue, Wash; and Lincoln Savings and Loan, Irvine, CA.

> With the benefit of five-years' hindsight, I am beginning to believe that Carter [Golembe] may be right [in arguing against my action]. Many (though not all) of the larger banks about which I was concerned have failed anyway and have almost certainly lost the FDIC more money than if they had failed earlier. And there can be no doubt that the thrift industry ran up far greater losses over the ensuing five years than would have been the case had we been forced to deal with the problems in 1984 (Issac, 1989, p. 5).[5]

Unless accompanied by a major breakdown in Federal Reserve policy, bank failures, even of large banks, do not lead to bank runs on noncontaminated banks and bank runs do not lead to the failure of economically solvent banks. Public policy makes should start tomorrow to remove the last vestiges of TLTF and impose pro-rata or similar haircuts on uninsured depositors and creditors at even the largest economically insolvent bank, just as policy makers now do at all insolvent bank holding companies, regardless of size. Too large to fail should be left to college basketball coaches and college presidents to fight over! In banking, too large to fail is too costly to continue (TLTFTCTC).

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[5] Recently, it appeared that Seidman had also had a change of mind. The Wall Street Journal quoted him during the demise of Drexel Burnham as saying:

> If the market floats through all this, then we have a greater stability than we had hoped... If this goes through, they may say the too-big-to-fail doctrine is gone for everyone. It could have that kind of influence.

(Murray and Salwen, 1990, p. A6). But he denied making this remark the next day in an interview with the American Banker (Garsson, 1990, pp. 1, 7).

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Statement No. 41

For information contact any
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Regulatory Committee

Statement of the Shadow Financial Regulatory Committee
on

An Outline of A Program for Deposit Insurance and Regulatory Reform

February 13, 1989.

The large number of current bank and thrift problems demonstrates clearly the inadequacy of federal regulatory policies and procedures to deal with insolvencies in a timely enough fashion to avoid undue financial burdens on both the insurance funds and the public at large. In particular, policies of regulatory forbearance and prolonged deferral of resolving problem cases, made possible by government insurance guarantees, permited economically insolvent institutions to keep operating. This has substantially increased the eventual costs of solving the problems which ultimately will be paid by taxpayers.

Fundamental reform is necessary and requires that: 1) the current regulatory and supervisory system be restructured to correct risk taking incentive problems and structural defects in the deposit insurance system, 2) an acceptable phase-in period be adopted so that solvent institutions would have time to adjust to the new regime, and 3) existing losses in the system be recognized as government liabilities and necessary steps taken to keep these losses from becoming larger.

The following proposal remedies major flaws in the system by minimizing incentives for insured depository institutions to take excessive risks. The proposal embodies:

* capital adequacy policies

* increased monitoring of asset values

* timely reorganization before a depository institution's economic capital is exhausted, and

* enhanced market incentives and rigorous supervisory enforcement

as the foundations for new supervisory and financial regulatory policies that would ensure an efficient financial system that is equitable and safe. The suggested program would not only improve regulatory performance but also foster greater discipline in managerial decision making. Managers of federally insured institutions must understand that the economic consequences of their actions would become known and that additional funds must be invested when capital falls to insufficient levels. Finally, owners, managers and uninsured creditors must know that the federal safety net would not support mismanaged or economically insolvent institutions. The following are the major components of the proposal:

CAPITAL POLICY

Establish four explicit, predetermined ranges or tranches of capital-to-asset ratios with differing supervisory policies applicable to each tranche as follows:

1. Tranche 1 - ADEQUATE CAPITAL (e.g., 10% of assets or greater) - banks with capital above this minimum amount would be subject to "normal" (i.e., minimal) regulation and supervision.

2. Tranche 2 - FIRST LEVEL OF SUPERVISORY CONCERN (e.g., 6-9.9% of assets) - once a depository institution's capital ratio falls into this range it would be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority would have the discretion to require the institution: a) to submit a business plan to raise sufficient capital to attain Tranche 1 within a specified period of time, b) to suspend dividend payments or unapproved transfers of funds within a holding company system, and c) to restrict permissible asset growth.

3. Tranche 3 - SECOND LEVEL OF SUPERVISORY CONCERN (e.g., 3-5.9% of assets) - when an institution's capital ratio falls into this range it would be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt and unapproved outflows of funds to an institution's parent or affiliates would be mandated. Asset growth would be prohibited to prevent institutions from attempting to "grow" out of their problems. The institution would be required to submit, in addition to the business plan to increase capital required in Tranche 2, an emergency plan for its immediate recapitalization to Tranche 1 level.

4. Tranche 4 - MANDATORY RECAPITALIZATION AND REORGANIZATION (e.g., less than 3% of assets) - The federal deposit insurance agency is mandated to place the institution in a conservatorship; delayed supervisory response has been one of the causes of the level of existing losses. This conservator-

ship would be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, sale of the entire organization or sale of individual assets. Present owners would have the option of implementing quickly the plan submitted when the institution moved into Tranche 3, or electing not to inject further funds into the institution. If the owners elect not to recapitalize the institution, it would be sold or liquidated, and any residual value from its sale or liquidation of assets would be returned to subordinated debt holders and shareholders, after allowing for any costs incurred.

KEY CLARIFICATIONS AND FEATURES OF THE PROPOSED STRUCTURE

1. DEFINITION OF CAPITAL - Capital is defined as the difference between the market value of assets and the market value of liabilities (including so-called off-balance sheet items) other than indebtedness counted as capital for regulatory purposes because it is subordinated to the claims of the deposit insurance agency and has a maturity of at least one year.

2. MARKET VALUES - The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions. As a matter of implementation, it is envisioned that market valuation estimates would have three sources: a) directly observed market prices, b) prices derived from instruments of comparable tenor including maturity, credit quality and rate, and c) estimates based on generally accepted valuation principles. Parties expected to be involved in the development of valuation standards and procedures include the regulatory agencies, public accountants, market and valuation experts, and the industry itself. Once the estimation programs are in place (as they already are in many institutions) valuations should be relevant to both management and the supervisors.

3. SUPERVISION COSTS - Charges for supervision, regulation, examination and monitoring would be based upon the efforts required of the supervisors and paid for by the depository institution. Because examination and monitoring efforts increase as an institution's capital declines and risks assumed increase, agency charges would function in a manner analogous to risk-adjusted insurance premiums.

4. CHARTER SHIFTING - Institutions would be permitted to change their primary regulatory agency within the new structure. This serves as an incentive for the respective agencies to balance the costs of supervision with its benefits to the agency and to limit over zealous supervision.

5. ACCOUNTABILITY OF SUPERVISORS - Federal bank supervisors must report publicly to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1.

Supervisors would be responsible for assuring that the business and recapitalization plans are appropriate and are acted upon. Periodic General Accounting Office audits and yearly congressional oversight would be required to provide an element of discipline on the regulators to operate in accordance with the required standards.

6. REGULATORY RESPONSIBILITY IN TRANCHE 4 - The appropriate federal deposit insurance agency would be notified when an institution moved into Tranche 3 and would receive all supervisory reports, and other information in anticipation of having to assume control of the institution as it moves into Tranche 4. All institutions falling into Tranche 4 should be reorganized regardless of their size. Their losses would be charged pro rata to uninsured creditors.

7. CREATION OF SUPERVISORY AUDIT TRAIL - Use of tranches and required consultations would document regulatory problems encountered in attempting to value firms as their capital declines and they move through the Tranches. This should simplify resolution of controversy should an institution be forced into recapitalization or reorganization.

8. INSURANCE PREMIUMS - Explicit charges for insurance should be low under this system since only fraud cases and unusual market movements would impose significant losses on the insurance funds.

9. HOLDING COMPANIES AND PERMISSIBLE ACTIVITIES - Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue. Use of the suggested valuation scheme, however, does suggest that the primary criterion relevant for establishing the suitability of a bank activity should be the ability of the insurance agency to monitor the activity and to estimate its market value.

10. INSURANCE COVERAGE - Present deposit insurance coverage of $ 100,000 per customer need not be changed for the proposal to be effective. Indeed, were the proposal to be adopted, it would be doubtful that any depositors would lose funds, except those involved in frauds on banks.

11. DISCLOSURE - Regular reports to the supervisors embodying the market value of banks should be publicly available. This

would enable the Congress and public to monitor better the status and financial condition of banks and the performance of the supervisory agencies.

12. LARGE BANK FAILURES - All institutions that fall into Tranche 4 should be reorganized or allowed to "fail" regardless of their size. Any losses should be charged pro rata to equity holders and uninsured creditors. "Failure" means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Policies which differentiate among firms based on their size (e.g., "too big to pay off") present unacceptable incentive problems, provide inequitable treatment of creditors, and foster unfair competition.

13. MARKET DISCIPLINE - Under this proposal the supervisory authority rarely would have to close or reorganize a bank. The suspension of dividends and interest payments on subordinated debt required when a bank falls into the second level of supervisory concern (Tranche 3) should bring actions by stock and debt holders to correct poor performance and inject more capital in the bank to keep it from being taken over by the insurance agency.

TRANSITION

Except for institutions with zero or negative GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as 5 years. Unless they are immediately recapitalized, GAAP-insolvent institutions would not be kept in operation. Institutions that are not GAAP-insolvent would plan for a three-year phase-in of the program ending in 1992 (the final effective date of the current "risk-adjusted" capital program).

DEALING WITH EXISTING LOSSES IN THE SYSTEM

Dealing effectively with existing losses in the system requires: first, that they be explicitly recognized as residual full faith and credit liabilities of the government rather than merely liabilities of the insurance funds; second, that insolvent institutions promptly be recapitalized and/or reorganized, merged, sold or liquidated; and third, that methods be devised for prompt disposal of assets acquired during reorganization of insolvent institutions. Any financing method not based upon the full faith and credit of the U.S. government would necessarily be more expensive and, given the magnitude of the existing problem, inappropriate.

The **Chairman**. Thank you very much, Dr. Kaufman. That is a very useful contribution as well, and I want to thank all of you.

Senator Graham has joined us. Senator Graham, do you have an opening comment to make?

Senator **Graham**. Mr. Chairman, I do not have an opening comment, but I wanted to commend you for holding this series of hearings on what is clearly a central issue. I hope that by doing so that this committee will be in a position as early as possible to be able to make some recommendations relative to how to apply lessons that have recently been learned and are continuing to be learned in the S&L situation to a more stable future.

The **Chairman**. Thank you very much, Senator Graham.

I want to just try to pose some yes or no questions that I think you won't find offensive, but I want to establish something of a common point of view if we can here.

My sense is that all of you are saying that if we're going to move in and broaden the powers and go through a restructuring in terms of what commercial banks can do that we must at the same time deal with deposit insurance, that we should not do one without the other. Is that right?

Mr. **Barth**. Yes, in my judgment.

Mr. **Bryan**. Yes.

Mr. **Kaufman**. Yes.

The **Chairman**. You all agree with that. Thank you.

I take it that you all agree that there is a pressing need for reform and change in the deposit insurance system itself; is that right?

Mr. **Barth**. Yes, exactly.

Mr. **Bryan**. Yes.

Mr. **Kaufman**. Yes.

The **Chairman**. I take it that you all feel that there needs to be a greater measure of market discipline. Now that can be private capital as the test or other things, but that you all think that a greater market discipline force has to be introduced by one means or another. Is that right?

Mr. **Barth**. Yes, appropriate incentives and market discipline.

Mr. **Bryan**. Yes.

Mr. **Kaufman**. Yes.

The **Chairman**. Do any of you think that the insurance limit ought to be lowered from the $100,000?

Mr. **Barth**. For me, I would not advocate that right now. It seems to me over time what will happen is that the limit will be eroded away by increases in prices.

The **Chairman**. By the increase in——

Mr. **Barth**. In prices basically. What happens is that inflation makes insurance worth less to individuals, price inflation.

The **Chairman**. I see.

Mr. Bryan.

Mr. **Bryan**. I am not in favor of it.

The **Chairman**. You're not in favor of reducing the $100,000?

Mr. **Bryan**. I don't think the place to get market force is within what I call the core bank. I think that depositors are depositors and they are not investors and that you can't expect them to act as investors.

The CHAIRMAN. Mr. Kaufman.

Mr. KAUFMAN. From purely economic grounds, I would favor it. But I think it would be very difficult to do, as you people know better than I do, and under our proposal with early intervention, since losses would be minimized, insurance effectively is redundant.

The CHAIRMAN. I want to move for the moment back to a question that I was pursuing with Mr. Bryan earlier, and that is what the potential risk may be out there now in the banking system because of some of the buildup and difficulty that were on the charts that he was showing us.

Is it your view, or did you feel, Mr. Barth, close enough to this issue to have a concern that if we were to get a recession along in there that we could find ourselves maybe with a very difficult problem in the Bank Insurance Fund?

Mr. BARTH. Sure. If there is a recession, then it's going to adversely affect banks and thrifts and everybody else in the country. I should point out that myself and Dan Brumbaugh, who is affiliated with Stanford University, and Robert Litan, who is affiliated with Brookings Institution, have been now asked by the House Banking Committee to study the adequacy of the FDIC insurance fund for banks. So it probably would be premature for me to say anything until we have actually completed this study.

The CHAIRMAN. Mr. Kaufman, do you think there is perhaps a new and larger risk to the insurance fund on the banking side if we were to have a recession come along at any time soon?

Mr. KAUFMAN. Well, it would be a continuation of the current risk. Certainly the losses might wipe out the reserves of the insurance fund. But since it's a full faith and credit guarantee, it's just a question of who pays for the losses, whether it's the banking system or the taxpayer.

The CHAIRMAN. Well, I think in the climate in which we are operating, I think the notion that we might burn through the reserves in the banking insurance fund would come as a great source of dismay and bring a great public outcry from all levels if that were to happen. Do you think there is a risk that that could happen here?

Mr. KAUFMAN. Oh, definitely.

The CHAIRMAN. How would you assess that risk?

Mr. KAUFMAN. I really don't know, but the reserves are about $13 or $14 billion. A lot of people claim that those are overstated. Indeed a statement released by the Shadow Financial Regulatory Committee a number of years ago estimated that the true reserves were probably in the magnitude of $5 to $10 billion. That's a couple of years ago. So they would probably be somewhat less now, and I don't think it would take a very major shock, as we found out in the S&L experience, to increase losses in the banking system below their capital by another $5 to $10 million.

The CHAIRMAN. Well, let me ask you a slightly different question related to this credit crunch that appears to be underway based on what we read and the anecdotal information and so forth.

Is it conceivable that we could have a tightening of credit of the kind that we were discussing earlier that could in effect unwittingly on the margin add another economic influence that could actually take us into a recession? We seem to be in a position in terms of our overall economy where that might be an unintended side effect of a credit crunch, if there is one taking place.

Mr. Barth.

Mr. Barth. One comment from the historical standpoint. One should realize that in the early 1930's the Federal regulators actually asked banks to make more loans. They thought that the bank examiners were being too tough on the banks, and therefore banks weren't extending the proper amount of credit.

Today one has to be sure that the institutions that aren't providing the credit are adequately capitalized. If that is the case, they certainly should be out there providing loans. That is what they are in business to do.

So what one doesn't want to do is have the pressure placed on the regulators to be basically telling banks to be making loans or extending credit when the institutions are inadequately capitalized. The capital requirements have been raised for a lot of the institutions and they feel that now is not the time to be expanding. So I think there should be pressure if pressure is placed on the institutions that are adequately capitalized.

The Chairman. Mr. Bryan.

Mr. Bryan. I think that we do bear that risk. I am at a loss to know how you can get a banker to lend if he doesn't want to because he doesn't like the risk that he sees, and I think the problem is, if this should happen, we are going to discover the costs of not reforming the system fundamentally over the last several years. I think to some extent if it's going to happen it's built in.

The Chairman. That's a very ominous point because that would lend weight to the argument that says maybe we have passed the point of no return some date that is behind us in the sense of not making the adjustments, and therefore we're now going to have a series of events play themselves out that we may not have great power to change.

Are you really saying that?

Mr. Bryan. No. I'm saying that to some extent we're going to have significant pain no matter what we do. We could make it, as I stated earlier, a good deal worse. I mean we are dealing with economic issues we haven't seen since the 1930's, and we don't need to see those again, and we have to be very careful.

There are various degrees of pain that we can experience, and we can make it a good deal worse if we are not careful.

The Chairman. Mr. Kaufman.

Mr. Kaufman. I don't know what to make of the complaints. I don't know how much weight to put on them. We hear this all the time. You remember back to 1986 and 1987 at the time you were talking about CEBA. Many people from Texas, Oklahoma and Louisiana came up here and voiced the same type of complaints. They were not getting credit. As we look back, they are the ones that should not have gotten credit to begin with. So you have to take some of these stories with a grain of salt, maybe a large grain of salt.

I think that Mr. Bryan made a very good point earlier that the excessive lending by the S&L's probably encouraged activity at that time, that if they had done more normal lending would not have happened. Consequently, the buildings that would have been built in 1990 were put up in 1986. So there probably will most likely be some fall in construction. But I need more solid evidence. I sit on the board of a bank, and I know that our loan to asset ratio is not falling. Maybe there is a change in the composition of credit, but I have seen no evidence of a fall in the loan to bank asset ratio.

So I am not quite sold that the complaints are legitimate in a macroeconomic sense as opposed to a microeconomic sense.

The CHAIRMAN. The bank you serve on would be in Illinois or where?

Mr. KAUFMAN. Oh, no. It's in Upstate New York, Western Upstate New York, the Rochester Community Savings Bank. It's a savings bank which has a 7 percent capital ratio, among the highest in the savings institutions area.

The CHAIRMAN. Said with some pride by the director.

Mr. KAUFMAN. A great deal of pride.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Well, Mr. Chairman, first of all, as my friend from Florida has previously has done, would like to express my profound appreciation to you for having these hearings.

I think that we are discussing here the most significant and important domestic problem in the country. Some might argue it's a deficit, but I would argue that if we don't solve this, the deficit problem is going to get a great deal worse.

And I am profoundly concerned about the lack of major concern, and I don't want to sound partisan by saying the administration, but in the Government as a whole about this problem. Clearly we already have a fantastically difficult problem with respect to the thrift situation. I think it's clear to members of this committee that we could face that problem again in commercial banking shortly if we don't do the responsible things, and I think all of you have made important suggestions. You've told us about the problem and we kind of know about that problem, and you've suggested some of the solutions.

I thank the Chair for asking you, first of ail, about the deposit insurance question. I think there is a basic agreement. Mr. Kaufman had some indication of dissent, but basic agreement, at least politically, that we shouldn't do anything about the $100,000 Federal deposit insurance amount.

Now would each of you, if I may ask you separately, and I understand there are other parts to this, but on the deposit insurance question, do the three of you think or do you have differences of opinion about whether we ought to have some kind of risk based deposit insurance system changing the system we have now?

Mr. BARTH. My view, as I have indicated——

Senator DIXON. I heard yours.

Mr. BARTH. I think that seems a worthwhile area to explore. The reason I say that is even the cross-guarantee program advocated by Bert Ely has the Federal Government in the background. Even Mr. Bryan's plan, and both of these plans are in some respects intellectually appealing, has the Federal Government in the background in the form of the Federal Reserve System to provide emergency funds.

Well, if the Government is in the background, it needs information to distinguish between solvent and insolvent institutions so as to determine which institutions to lend to in the case of the Federal Reserve, which is mentioned in Mr. Lowell Bryan's plan.

So what I would like to do is rather than have the Government in the background trying to assess risk and determine which institutions are solvent or insolvent is to have the private sector do more of that, so as to impose market discipline on the Government, and to me that could be done through a system of coinsurance or reinsurance whereby the private sector with some capital at risk would indeed assess the riskiness of institutions and then price that risk.

What those prices would do, it seems to me, is force the Government to look at those prices and perhaps even use them and then have to be in a position of responding to those prices. If the prices that the private sector establishes for the riskiness of institutions get very high or indeed the prices reach the point at which one would want to terminate insurance or people want to leave institutions, then it seems to me there would be pressure on the Federal Government to close or reorganize institutions in a timely and cost effective manner.

That is what I see to be the benefit of some sort of pricing scheme implemented by the private sector with their own capital at risk. What they would do is ensure, it seems to me, what didn't have in the case of the thrift institutions, that there would be timely and appropriate reorganization or closure, and that incidentally seem somewhat lacking in Mr. Kaufman's proposal, though it, too, contains most of the elements that I think are extremely important.

Senator DIXON. Mr. Bryan.

Mr. BRYAN. I am a skeptic on risk-based deposit insurance for the following reason. You have to underwrite credit at the source, and it's very difficult for an outsider, given the complexity of credit risk, to be able to do that before the fact. I don't know how you would set a mechanism in place that would actually work for setting the insurance premiums that would be effective.

The real difficulty I believe is if you do it after the fact, then you often are penalizing the new management, because old management has been kicked out in a situation where the Government has already exposed the risk.

On the private sector basis, I despair of finding the private capital available to underwrite the kind of risks that banks ordinarily take, even well capitalized banks, and I think you might find the cost of a true market system prohibitive and it might lead to a greater credit crunch than the ones we have been talking about today.

Senator DIXON. I wonder if I could send you a letter shortly, Mr. Bryan, outlining my thoughts about a percentage of risk in banks over a certain stated amount and see whether you have some thoughts about that when you review it.

Mr. BRYAN. There may well be some variations that could make some sense. I just don't see it for big banks with complex risks as enough of a solution that I think you're going to have to rely on.

Senator DIXON. Well, you're kind of suggesting in your testimony, if you will permit me for interrupting you, sort of a compartmentalization of the risk in the institution, are you not?

Mr. BRYAN. Yes.

Senator DIXON. And I'm wondering how feasible that is really going to be if we are able to accomplish something of that sort, and whether you really will have the kind of firewalls ultimately that will be protective, or whether you're going to end up having the same experience that we have with thrifts?

Mr. BRYAN. I think it is quite possible if you deal with intercompany transactions. I mean the FDIC has been able to get most of its recovery from the capital that they have forced people to invest in banks. I think we need to strengthen some of those transactions. I think the biggest thing is institutions in distress can't be allowed to move assets around, and I think that was shown in the Drexel case. You've got to be very careful with it, but I think if you really work very hard on intercompany transactions, that you can in fact create effective firewalls.

Frankly, you start having the market bear some real risk in the holding company structures by liquidating subs that are not guaranteed, and you will see how much market discipline you can create. I think it will wind up in recapitalizing those elements of the industry, and that's how I think how to get the market to work. I really despair of being able go risk-based deposit insurance premiums.

Senator DIXON. Mr. Kaufman.

Mr. KAUFMAN. I share some of Mr. Bryan's skepticism about the effectiveness of risk-based insurance premiums. In addition, it does not deal with the greatest loss potential to the deposit insurance agency, and that is failure to close the institution when its net worth reaches zero.

If you have no insurance, for example, and you could close an institution and reorganize it and recapitalize it, and we don't mean to close it up in terms of putting boards over their teller cages of course, just at the time its capital reaches zero, then there are no losses to anybody.

So the whole secret ought to be more timely intervention, and since we make errors, we should intervene prior to the time that the capital is depleted totally. So the solution I think, a much easier one, is just much higher capital and more timely closure policies.

Senator DIXON. How would you ensure that though? I don't want to be the skunk at the picnic, but don't we see the evidence that the regulatory system has failed over the last decade pretty substantially in bringing us to the place where we are right now?

Mr. KAUFMAN. Right——

Senator DIXON. I mean the regulators could have done a lot to prevent the problem that we see out there right now. I want to be fair about this, but I thought I was Mr. Corrigan, Mr. Chairman——

The CHAIRMAN. It probably was.

[Staff member nods affirmatively.]

Senator DIXON. I see someone nodding yes here—who suggested to us, I think a highly respected guy, and wasn't it you, Mr. Bryan, who mentioned his name a moment ago in your testimony, or one of you mentioned Mr. Corrigan along with Mr. Greenspan.

Mr. KAUFMAN. I think I mentioned him.

Senator DIXON. It was Mr. Kaufman that made that point one time when he was here that I thoroughly agreed with, where were the regulators this last decade while all of this terrible tragedy was unfolding that has led us to this national scandal that leaves us in a situation where even Mr. Bryan cannot suggest any longer how tremendous the loss out there is, this uncounted loss.

Mr. KAUFMAN. Some of my best friends are regulators.

Senator DIXON. Well, I guess some of mine are, too, but somebody messed up somewhere.

Mr. KAUFMAN. Right, and I do believe that they learned, and that now it is quite evident, both to the regulators and hopefully the Congress that is supervising the regulators, that the cost of forbearance is very, very high. That is why I ended my statement saying that early intervention is not effective unless it is made mandatory. So we have to get agreement from the regulators and from Congress that we will not be swayed by pleas, such as credit crunches, and that if a bank's capital is used up, it is closed, which doesn't mean that the bank disappears. It's sold and merged and the loan officers stay the same generally. Only senior management changes and the sign over the door changes.

Mr. BARTH. Could I add that I don't disagree with George Kaufman. I think we all agree that all the proposals, in my view, if one looks at them deeply and carefully, share the common elements of more capital, more market based information and early reorganization or closure. That's my statement.

However, I think to impress upon the Government or the regulator that it is indeed important to engage or put that early closure or reorganization rule into effect, one could have the private sector in some limited way or at the margin provide some information through independent risk assessment, and that information could assist, it seems to me, the Federal insurer to move in a more timely and cost effective manner against institutions.

One is not talking about trying to put the private sector at such risk that widespread runs might again become significant, but one is trying to elicit more information from the private sector to assist the Federal insurer in moving in a more timely and cost effective manner, and I think that is the point that you're making, Senator Dixon.

Senator DIXON. Mr. Bryan, I'm anxious to hear from you.

I see the red light, but this is important.

The CHAIRMAN. Go ahead.

Senator DIXON. I appreciate it.

Mr. BRYAN. I am in favor of many of Mr. Kaufman's points. There is a real dilemma that you have to deal with. Where is all this capital going to come from. Unless the activities are economic, in other words, unless you have a reasonable return on capital, you cannot bring the capital into the system.

That's the reason why I think we have got to get those activities out of the bank which don't belong in the bank. That's why I'm in favor of narrowing the activities that are in the bank to those that there truly is no other alternative provider for, and therefore you can have a safe depository system, and you can then charge depositors for the cost of that safety, and borrowers who have no other good available economic solution to use the bank, which are small business individuals, and the rest of the activity should be migrated to places where the market can discipline so we don't have to get into arguments about how much capital is needed. The market says you need this capital, and if people make bad judgments, they suffer the losses and not the Federal Government.

We have all been wrestling with this issue for years, that the other approaches really do not work anywhere nearly as cleanly as that one approach because if you do have an anomaly called deposit insurance, and the entity that is creating the anomaly, i.e., the Federal Government, has to make sure it's not abused.

Yet, like it or not, there are fully unleased economic and market forces that none of us can control, and the issue is how do we then channel those constructively rather than destructively.

That's the reason why I favor the segregated core bank approach because I think the core bank contains those activities that are fundamentally economic in banking. By the way, our analysis shows all the existing profits are coming from those activities right now.

Senator DIXON. What does your early intervention law mandate to the regulator, Mr. Kaufman, or upon the regulator?

Mr. KAUFMAN. Well, we have a series of tranches so that the early closure does not come like a shot out of the blue. At some level, and let me give you some hypothetical numbers, maybe at a 10 percent capital asset ratio as a bank breaches that tranche, the supervisors and the regulators are put on their guard. At that time they start initiating action limiting the powers of the banks and monitoring more carefully. If the bank finds that this cost is not high enough and deteriorates further, maybe to a 6-percent capital to asset ratio, at that point the regulators could suspend dividend payments. It could suspend interest payments on the subordinated debt, which would bring the private market into play.

So hopefully by increasing the cost of poor performance at banks, they will never come to that last tranche and the marketplace will close the institution prior to the time that the regulators——

Senator DIXON. Well, if I may interrupt, are you really suggesting to us that we legislate these things at different scheduled levels? I mean how much discretion are we going to leave to the regulators?

See, I hear what you are saying. You know, it's one thing to say that, but it's another thing—are you suggesting to us that we really legislate these things?

Mr. KAUFMAN. No.

Senator DIXON. Are you saying trust the regulators, because when you say that, a lot of people out there are going to say, wait, we trusted the regulators. They messed up.

Mr. KAUFMAN. I'm saying a combination. I think the only level that needs to be legislated is the reorganization level, and the rest just to legislate that there is a tranche system. Where the levels come for each of the tranches should be left up to the regulators. They are the most knowledgeable and they are the closest. But to relieve the pressure off the regulators I think it is necessary that the last tranche, the reorganization tranche be legislated by Congress.

Senator DIXON. I would be interested, if I may pursue that just a bit further, Mr. Chairman——

The CHAIRMAN. Sure.

Senator DIXON. I would be very interested, Mr. Kaufman, hearing in some detail through my staff and others your idea about how we accomplish that.

Mr. KAUFMAN. I would be glad to do so.

Senator DIXON. If I may pursue this further, Mr. Chairman.

The CHAIRMAN. Sure.

Senator DIXON. Who would you say ought to bring us the correct mix of the things we do with the deposit insurance system, early intervention, change in the composition of what a bank is going to be for the future and stuff like that, who ought to do that? Who ought to bring that to us?

Mr. BRYAN. Do you mean who ought to bring the proposal for fundamental reform to you?

Senator DIXON. Yes.

Mr. BRYAN. I think that should be done by the administration I believe.

Senator DIXON. Well, I certainly think so, too. I mean I think each one of the members here on each side of the aisle has a separate idea. While I respect your view, I think I like more the view by Mr. Barth that some kind of a risk-based deposit insurance system with this other mix of early intervention and a new form of how we compartmentalize risks within institutions, all of that together can ultimately work, but it occurs to me that every one of the members of this committee is probably a sponsor or co-sponsor of some different bill with different ideas, but nobody is coming to us either from the Fed or the administration or anywhere else to address this major problem in the country.

Mr. BRYAN. My understanding is that they are planning to do it early next year.

Senator DIXON. Well, I hope it will be an apt time.

Mr. BRYAN. The costs of delay are large, the issues are fundamental, and I hope that we do it right this time.

Mr. BARTH. Could I just add one comment. What concerns me again about the early closure or reorganization rule is the fact that we have over 500 institutions listed—in the paper at the back of my prepared testimony based upon the most recent data that are open and insolvent, over 500 institutions with $200 billion in assets. One did not need market value information. One basically needed a little bit of common sense to know that those institutions were deeply troubled. Common sense and not market value information would have done the trick, and it seems to me that that discipline wasn't imposed.

What I am suggesting is that one should have the marketplace impose more discipline to assist the Federal Government or the deposit insurer, and I think that is the advantage of going towards some sort of sharing of the risk and then adequately pricing that risk to provide information.

I think perhaps there was a bit too much reliance upon a single insurer in the case of the thrift institutions. There was a lot of pressure on the insurer, and perhaps too much, and the market could have assisted the insurer by absorbing some of that pressure and indeed thereby protecting the insurer.

Senator DIXON. I would say that I share that view.

Mr. Chairman, I would just observe that the contributions made by these three witnesses I think is a very substantial one.

I continue to say, as I have said to you in private, as I have said in this committee, and as I have said on the floor of the U.S. Senate and other places, this is the most important domestic problem in the country. The mistakes that have already been made, there is probably very little we can do about them, quite candidly, but I think that we ought to be getting in a position to find some solution to what obviously is a major problem that we have not adequately addressed, and I don't mean that critically of anybody on this committee.

I think the administration with all of the expertise it has and the various departments of Government that are jurisdictional over this question ought to be coming to us, in my view, now to suggest solutions.

The CHAIRMAN. Let me just say, Senator Dixon, that your thoughts trigger several thoughts in me, and I agree with that, that I think this panel has been particularly helpful to us today, and I want to say again how much I appreciate their work and their time with us.

I think that we do have the right to expect the administration to come forward with a proposal, and the sounding one gets is they are circling this problem and in due course we will have a proposal, maybe sometime early next year. Whether it will be seen as a top operational priority or whether it will go on the short list of two or three things that the administration hopes to try to accomplish in 1991, for example, we just don't have a clear signal one way or the other.

But my own view would be this, Senator Dixon, and we have exchanged a lot of thoughts on this. I think at the point at which we feel that we are able as a committee to offer an approach of a restructuring proposal, to the extent we reach the point here in terms of a collected opinion within the committee, not necessarily all the members of the committee, but some number of members of the committee, that I would not at all foreclose the possibility of us putting a proposal forward. I don't think we are ready to do that yet, because this is an enormously complex issue, and we are coming down through this hearing schedule of 13 hearings, but precisely with the idea in mind of being able to make a competent, professional judgment.

Whether it will be precisely what the administration in its deliberations eventually comes to or substantially different than that, I think we have an obligation here to do our work, and we'll do it.

I must say that with respect to the narrow bank concept that you've been describing today, Mr. Bryan, that the idea of lining up the scope of the banking activities with the deposit insurance foundation underneath it has a real appeal to me. Now how broad or narrow that narrow definition is that lines up with deposit insurance I think takes some further thought and analysis.

I like the idea, however, of disconnecting deposit insurance from anything that is outside that definition of activities. I don't think we need another savings and loan collapse to tell us that, and I think the historic data that you've already developed with respect to the buildup of problems in commercial banking is enough to tell us that we have a real exposure out there. If we are lucky, maybe we don't see a major problem develop, but certainly one could.

So I think that we are going to have to find a way to take and make sure that the deposit insurance guarantee is within very prudent bounds from the point of view of the taxpayer, and I just think even the inherent stability of the system, and I think there is a limit to what any regulatory structure, no matter how well designed and no matter how conscientious the regulators are themselves, the degree to which they can go in and apply on a real time basis a wall-to-wall discipline that is necessarily going to be accurate, timely and give us the results we need.

I'm much more inclined, other things being equal, to letting the rough equities of the marketplace decide where capital should or shouldn't go, and if people are betting their own money, I think they are going to be pretty careful in most cases as to where it goes.

So I think that system works quite well generally speaking in our society, apart from the deposit insurance type situations. So I think the market may well have greater sophistication and greater ability to take and measure risks and the tradeoffs and move capital around than we can with some incredibly elaborate regulatory scheme.

So I am inclined to feel that we ought to really think through carefully this question of where deposit insurance begins and ends and what is in that bundle of activities and what is outside.

Now the next question that leads me to is the rest of the world because we see this increasingly global economy and the cosmopolitan world of international players, and I think it's very important that we have a working model that fits the domestic realities of the United States in terms of safety and soundness and macroeconomic policy and monetary policy transmission and lot of other things, the payment system, and at the same time will allow us to gear into the rest of the way the world is working.

So I would like to hear, starting with you, Mr. Bryan, how, if you were to go with a more narrow bank concept as you speak about it, and then you have all of these related uninsured activities that are out under some set of structures, holding company arrangements or affiliates of one kind or another, how does that model start to line up with the way the rest of the world is developing its financial services character, Europe in 1992, the Asians and so forth, and would that lead us on an international competitive footing that would allow us to go out and hold our own in terms of being able to compete internationally in financial services?

Senator DIXON. Mr. Chairman, may I interrupt before Mr. Bryan answers, and I apologize, Mr. Bryan to you and the witnesses, and to you, Mr. Chairman. I am beginning to get all kinds of notes from my office about appointments backing up and I must leave. I find this tremendously interesting. It's a thing that you know that I have an interest in, and you and I have shared private discussions and other things, and I would just like to respond to something you said, Mr. Chairman.

I think if the administration isn't going to come to us with some kernel of an idea about how we ought to go forward on this shortly, that those of us on this committee ought to begin to have some meetings, as we have had in the past, some of those private meetings to discuss our own ideas of how we might develop our thoughts about the deposit insurance system, early intervention, the form that these commercial banks ought to take and things of that kind at some time in the near future and begin to exchange ideas with folks like these good witnesses and others and see whether we can come to our conclusion separately about what ought to be done.

The administration is always welcome to make its contributions, but I sincerely believe that we would be ill advised to just languish through the years and see what happens next year. I think the problem is sufficiently important, and I would hope that Mr. Barth, Mr. Bryan, and Mr. Kaufman feel that way as well, that we ought to be trying to develop some kind of a sensible, reasonable solution to it at the earliest possible date.

The CHAIRMAN. I appreciate that comment.

Senator DIXON. I thank the Chair for a very interesting hearing. I apologize to the witnesses for having to leave.

The CHAIRMAN. May I ask now for a response on this question of how that model might then gear into this new global financial system.

Mr. BRYAN. Well, first of all, let me talk about the core bank. There are two issues here. First, is how competitive are our institutions in world markets and in the United States, how they stack up, and the second issue is how does the regulatory model fit.

In terms of the first, what I think would happen if we went to this kind of a core bank concept that I was talking about is that there are some natural consolidation forces at work in the nation, and in the process of resolving the insolvents and the undercapitalized institutions, those would wind up in the hands of the strongest players. I think we could wind up with some 15 to 20 very large core banks which because they would be cost effective and they would be highly skilled—could stand tall in world markets in terms of market capitalization and would be the guts of financing our regional economies.

I think we could see $250 or $300 billion institutions built up from core banks that would be perfectly economic institutions operating without subsidy, basically the equivalent of the baby Bells, though with more competition than the baby Bells face, but that kind of is the structure.

Second, I think that the good news about the 1980's, despite the cost, is that we did go a long way down the road of increasing the competitiveness of our institutions. We, in fact, despite our problems, have better skilled bankers than we had 10 years ago. They work harder, they are smarter and they have higher skill.

They have made some mistakes in judgment under pressure, some of them, but the net is we have a lot of benefit from the 10 years. If we can get through the other side and have market forces disciplining those folks, we have a real upside opportunity in global markets. I think that we have very highly skilled commercial and investment bankers that operate in the money market that I talked about, and we have very highly skilled people in all the other non-bank businesses.

Now in terms of the regulatory model issue, I do not think we can wind up with a completely harmonized regulatory structure because of the difficulties of the conditions that exist in each of the parts of the world.

In Japan they do have an article in their Constitution which forbids holding companies. So they are going to have to go, if they go, to a segregated model; they will have to make them subs of banks as opposed to allowing holding companies. But I think that we can accommodate that. I think that's fine.

The universal banking issues in Europe are significant. They have bundled all of their activities in one big universal bank. I suspect that what you are going to see is that Europe in 1992 is going to lead to those institutions experiencing the same difficulties that our institutions had in the 1980's, that is as the forces for competition are unleashed in Europe, I think we are going to see a repeat of our experience. In fact, you are already beginning to see it. There will be excessive risk-taking and they will have to reform their own system some 8 to 10 years from now.

The CHAIRMAN. They will all hurry to get those bad loans with those good front-end fees.

Mr. BRYAN. That's right.

The CHAIRMAN. Mr. Barth.

Mr. BARTH. Yes. I should point out that as regards the narrow bank, again looking back, the great American economist, Irving Fisher, testified before the Congress in the early 1930's in favor of a narrow bank. So it's nothing new, and he point out that indeed one should have two types of banks, the narrow bank or the payments portion separate from the credit portion of the bank.

The concern that I have is with respect to the credit portion where it will create problems through Government intervention. But I think if one starts moving in that direction, one does have to be cognizant of what is happening in other countries, and the fact that they don't have such a similar system and whether or not it does indeed put our banks at a competitive disadvantage.

The CHAIRMAN. Mr. Kaufman.

Mr. KAUFMAN I find the narrow bank a concept intuitively appealing until you look at it in detail, and then it becomes less appealing.

As it was originally conceived many years ago, and as Mr. Bryan and one of my co-authors in a study that Brookings published about a year ago, Bob Litan, had it, it would be a core bank with only safe investments. Well, if that is the case, then this bank cannot earn enough to attract deposits from the other institutions that were holding what I guess you could call non-safe assets. You would have disintermediation and the core banks would be very small. Then you run into the same problem of what do you do with the other institutions when they get into trouble.

As a result, Bob Litan has expanded his definition of the narrow bank beyond safe investments to anything that can be marked to market. So that if it can be marked to market, then it can be put into the narrow bank. That of course broadens its activities considerably, and that comes then very, very close to the early intervention rule. For anything that can be marked-to-market, you know whether the bank has positive capital or not.

That concept of a narrow bank really is not a narrow bank and would be more or less what we have today. Because the banks are told that they are limited to including only assets that can be marked-to-market, market forces will develop very quickly that will mark almost anything to market. In this case we will end up with a bank very similar to what we have in Europe and keep American banks competitive with the trend in Europe.

The CHAIRMAN. Mr. Barth, when were you the Chief Economist at the OTS?

Mr. BARTH. From September 1987 until November of last year.

The CHAIRMAN. Now you were there as this thing was sort of peaking then in terms of the travails of the 1980's. In 1987 after you had been aboard for say 6 months, and I am not trying to paint you into a corner, but I just want your professional opinion about something, when you had been there for 6 months or so, did you and others that were there foresee the scale of the financial collapse that was up ahead of us, or was this something that was, not to single you out, but you and others there just had not imagined could take this form or not? Or did you see it coming and did you ring the bell and where there are lot of people there saying, you know, let's get the brakes on this thing and this is where we are headed?

Mr. BARTH. It's an appropriate question and you can single me out since I was there. I must admit I was not on the executive committee. I was put on the executive committee once I indicated that I was going to leave. So I spent 2 years there before I was put on the executive committee. So I never once in 2 years met with the chairman and the other 6 members of the executive committee to discuss these sorts of issues fully.

I should point that on July 22, 1987, and again I went to the Bank Board in September, or about a month or 6 weeks after, something was published in the New York Times. I did an op-ed piece with Dan Brumbaugh. Here is what we said: "The bill then proposes to spend a total of $8.5 billion. The sum would barely keep pace with the escalating costs of closing them. Congress and the taxpayers must acknowledge that a sum far greater than $8.5 billion or even $15 billion will be needed to close insolvent savings and loan associations. Although the thrifts should bear part of the cost, they cannot bear it all. Thus, general revenues, taxpayer dollars will be needed."

When one writes an op-ed piece in the New York Times, it seems to me, 4 or 5 weeks before one goes to the agency, most of one's views are publicly known not just within the agency, but throughout the country. So basically I expressed my concerns in print publicly for the whole world to read and ask me about, and within the agency of course I had some concerns about the solvency of the FSLIC and the ability for not only health institutions, but other financial institutions to compete with hopelessly insolvent institutions.

The CHAIRMAN. Well, let me just take it a step further. Obviously you and that op-ed piece were indicating a concern that could take $7 or $8 billion or even $15 billion. We're looking at numbers that are several orders of magnitude higher than that, and this is not again to try to paint you into a corner, but the sense that I have, and you tell me if I am wrong, that within the Bank Board in 1987 and even in early 1988 the notion that we were going to see a $100 billion blowout was not on the radar screen of the policymakers there.

Were you saying that at the time internally or was anybody else? I mean that is where we are now and that's what it looks like today. Did anybody see that coming in those magnitudes?

Mr. BARTH. Outside the Bank Board certainly Mr. Lowell Bryan indicated——

The CHAIRMAN. I'm talking about inside the Bank Board. You were inside. I'm saying inside the Bank Board, did anybody see it inside? I mean the point is there had to be a range of opinion and there had to be some sizing of this problem. Now we were getting it in testimony across these tables and so forth, and what we were getting in written testimony tended to size the problem down quite frankly.

I'm wondering if internally there was any serious debate of people who were sizing it up to the orders of magnitude that we now find it to be, and that is in the $100 billion plus range in terms of net losses?

Mr. BARTH. The numbers, as we know, tended to evolve over time, and indeed I provide in the paper that is attached to my testimony the historical evolution of the numbers and the rationale that individuals used to calculate those numbers, including the Federal Home Loan Bank Board.

Inside the agency there was after a period of time some disagreement that was expressed among the Board members themselves. It turns out that Roger Martin, a Board member, did publicly express disagreements with the official Bank Board estimates.

The staff by and large were not asked to provide internal estimates. For the most part, I was not officially asked, and my view was fairly well known, to do that. The Board instead I think went to the Federal Home Loan Banks in the districts and asked them to provide information by which cost estimates could be put together. It also turns out that the Board tended to emphasize accounting type numbers, that is to say it said it had to come up with accounting numbers to satisfy the auditor, which was the General Accounting Office, which based most of its numbers, for the most part at least, only on generally accepted accounting principles. You only book that which you can be reasonably sure about.

So there was a lot of discussion about accounting numbers and not so much what we have described here as estimates of the market value numbers.

The CHAIRMAN. Well, I asked the question for a couple of reasons. One of the reasons is that I'm wondering what the psychology might be like these days within the FDIC as it relates to the BIF fund and whether people are, you know, sitting around these days and cogitating and thinking that maybe we've got a problem of this size, but maybe we really have a problem of this size.

It seems to me that to put you in and leave you out over at the Federal Home Loan Bank Board, it looks to me as if as an entity the Board substantially undershot the mark. Consciously or unconsciously, the size of the problem dwarfed anything that anybody inside seems to have thought was happening. I mean if they knew it, it certainly didn't really the light of day in the magnitudes that we're now seeing. And I'm not saying that so much as a matter of trying to sort of figure out who was where and their opinions at that time.

I'm trying to understand, and I would like to see us get ahead of the curve once in a while in this country on these major policy issues, and that is what we are in effect trying to do here with respect to the banking system and how it ought to be restructured and how we ought to change deposit insurance for the future and so forth.

But I'm wondering right now what the psychology may well be within the people who are charged to make these assessments within the banking system today and whether we could be in a sense in a situation where we may well have a larger potential problem than anybody can see or is prepared to try to acknowledge.

Mr. **Bryan**. I think that we are in terms of economic loss, and because the industry is bigger there are issues, but we should not forget that there is roughly $250 billion of equity capital in the banking system. The problem is mostly that capital is not available to cross-subsidize the weakest players. There is a better economic franchise and remember everyone has watched what happened with the thrift industry.

I would say that given our earlier concerns about credit crunch and so forth, I would say that the regulators are completely on their guard now about the potential problems. In my discussions with them they seem to be very proactively looking at the issues.

I think it's more equivalent to say it would have been if we had looked at the savings and loans industry in 1984 or 1985 and not in 1987 or 1988. We are ahead of the curve if we act on commercial banks now. If we don't act, 5 years from now we could have a commercial banking industry in the kind of shape that we wound up with the thrift industry in 1987.

The **Chairman**. Well, I don't know. I mean I hope you're right because that sort of cuts against some of your earlier testimony here today.

Mr. **Bryan**. No, I'm talking about the economic issue. I was talking just very narrowly about the magnitude of the loss, because going through the insurance fund means something different in an industry that has $250 billion of capital. You have some potential to recapitalize through increases in deposit insurance premiums and so forth if you keep the franchise value.

I still have some hope that we can get through any problems with the FDIC without an economic loss to the Government if we act soon.

Mr. **Barth**. I have some concerns myself. One thing I would like to state for the record is I have some concerns in part because of the information within the agency. I'm not so sure there is proper information. I'm not sure it's adequately dispensed to other people who are experts in this areas, academics and others on the outside.

I should say this, that I have talked to people on your own staff, and you have a very competent staff, people are very knowledgeable and have written about these issues in a way in which I have learned from their writings and from discussions with them, and they inform me occasionally that they cannot get information from places like the Federal Home Loan Bank Board and the Office of Thrift Supervision.

Somebody told me at the Congressional Budget Office just a couple of days ago that he is unable to get information about troubled institutions from the Office of Thrift Supervision. And this is despite all that has happened.

When I was there we had a policy of giving out all sorts of information. Indeed, I occasionally had problems when I gave information to the Congress or to the press, but I think one has to encourage these agencies to share for the most part publicly available information, and then we can tell more about the financial condition of the institutions and the insurance funds themselves. That does concern me, the information. I'm not so sure that responsible people in the Congress and the agencies are still provided with sufficient access to relevant information at such crucial points of time.

The CHAIRMAN. Mr. Kaufman, please respond, too.

Mr. KAUFMAN. I can support what Jim Barth just said. I remember in the mid-1980's when people were making independent estimates of the size of the deficit, they did not get the cooperation of the agencies. They had to use information that was not as good as the information available to the agencies because the correct information was not provided to them. Consequently, when they came up with estimates that the agencies did not like, they were criticized for not having the right information and making wild guesses.

I think it is very important that Congress insist that the information be made available and that people could use this information to make their own estimates. I think there is a natural tendency of regulators to be rather cautious in predicting a decline of an insurance fund that would increase the cost to the taxpayer.

I think if Dick Pratt had come here to Congress in 1982 and said what he says now, that as a result of interest rate risk the deficit in the savings and loan industry was $100 billion, he might not have been around long, but the country would have been a lot better off.

The CHAIRMAN. Well, we will have some questions for you for the record from some of the colleagues who very much want to be involved in this debate and were not able to be here this morning.

I want to thank all of you again, and we look forward to continuing to maintain the dialogue. As we develop our ideas, we would like to be able to talk with you and have you think with us.

We thank all of you.

The committee stands in recess.

[The committee adjourned at 11:55 a.m., subject to the call of the Chair.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

WEDNESDAY, JUNE 13, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m. in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Shelby, Heinz, Dixon, D'Amato, Graham, and Bryan.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance, and let me most especially welcome our very distinguished witnesses today and say how much the committee and the Senate as a whole appreciates your attendance. You have all come from some great distance to be here, and that is greatly appreciated.

I want to indicate at the outset this morning that when we schedule these hearings we have no way of knowing what else will be going as the day of the hearing arrives, but we have a host of other activities taking place, including the fact that the Senate is in session this morning with major amendments on the floor.

I have a note here from Senator Garn, the ranking member, who has informed me that he very much wants to be here this morning and hear the opening statements of our witnesses. He is unable to be present at the start of the hearing. He has been detained first at a Rules Committee markup, and then leaving that must go immediately to the Senate floor for an amendment that he is involved in handling, which is coming up on the floor, and when that is disposed of, it's his intention to come here and hopefully at that time take part in the question and answer portion of today's hearings.

So Senator Garn, very particularly, wanted me to express his personal appreciation for your testimony and wanted you to know the circumstances for his absence at the moment.

Let me now make some opening comments of my own, and then I want to yield to Senator Shelby.

I am very pleased on behalf of the Banking Committee today to welcome distinguished top-management officials from three of the most respected financial institutions in the world.

The committee is most appreciative that Mr. Peter Leslie, Deputy Chairman of the Barclays Group of London is here; Mr.

Ulrich Cartellieri is here, a Member of the Managing Board of that Bank in Germany of course; and Mr. Toru Kusukawa is here representing the Fuji Bank. He is the Deputy President of that Bank of course based in Japan.

As I said earlier, they have all been very gracious about taking time away from very busy schedules to come a great distance to help give us a better understanding of financial market developments in their countries and in a sense in this new global economy that we are all a part of.

I would say for the record and for their background as well that this morning's hearing is the 8th in a series of 13 that we are holding this year regarding the need to modernize the regulation of the financial services industry here in the United States.

In April we heard from representatives of American banking, securities, real estate and insurance industries. In May our hearings focused on various proposals developed by academic and other experts to reform our deposit insurance system.

In May we also heard from Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, that deposit insurance reform and modernization of our financial system are needed as he would see it.

Today, we begin the first of three hearings in the month of June in which we are attempting to obtain a better understanding of financial service developments and trends in Europe and Japan and their potential impact on the competitiveness of U.S. financial institutions both abroad and here in our domestic market.

In this vein Treasury Secretary Brady will be here and at the witness table to testify in just a few days from now on June 26 to discuss these same matters, and then in July we will be hearing from the regulators.

Federal Reserve Board Chairman Greenspan will testify on July 12. FDIC Chairman Seidman and the Comptroller of the Currency on July 17, and the SEC Chairman, Mr. Breedon, on July 19. So it will help you have some sense as to the manner in which we are working our way through this issue and these set of issues.

Now each of today's witnesses has been asked to address the following matters in their prepared testimony.

First, what activities are permissible for banking organizations in their own home countries compared to those that are permitted to banks in the United States?

How would each compare the bank and financial regulatory and supervisory practices in their own countries with that that they see and observe, and must work with here in the United States?

What are the differences in our respective systems of deposit insurance and what their attitudes would be country by country toward financially troubled institutions?

How would each envision the global financial services industry evolving over the next several years and, in view of Europe 1992, what trends and developments should we be most aware of in considering how to modernize our own system?

So I want to again thank our witnesses at the outset for being here and in addition for their very thorough and thoughtful prepared statements which they have prepared and submitted to the committee.

Those statements will be included in full in the committee record, and they will be a very valuable reference document for our committee and for others in the Government as we consider this. So I want you to feel free to move off your text at any point you wish either in raising additional points or emphasizing points or in reacting to something that one of the other witnesses may have brought forward.

With that, let me yield to Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I just want to be brief, and I would like for my full statement to be made part of the record so we can get into the witnesses.

The CHAIRMAN. The statement will be made part of the record.

Senator SHELBY. But I do want to commend you for scheduling, Mr. Chairman, just an excellent panel of witnesses and for enticing them to come from far away to Washington to present their views of a changing financial market globally speaking to this committee.

I believe the fact that these distinguished witnesses made long trips from their own countries is indicative of the fact of how serious the limitations are in the United States financial services industry. So we are looking forward to your testimony and hope that we can learn something from what you're doing in your respective countries.

Thank you, Mr. Chairman.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, you are to be commended for scheduling such an excellent panel of witnesses this morning and for enticing them to travel this far to particulate in this morning's hearing.

I believe that the fact that these distinguished witnesses made the long trips from their home countries testifies to the seriousness of the limitations in the United States financial services industry.

We speak of a world whose nations have become increasingly interdependent, we acknowledge that the financial services industry, perhaps more so than almost any other industry, has become globalized. But the fact that today's witnesses, our competitors, have come to emphasize to us the seriousness of the shortcoming of the United States financial services should convince us that it is time to modernize the laws governing the financial services industry.

The efficiency of our economy is dependent upon the efficiency of our financial services industry and in an increasingly interdependent world of nations, there can be no "weak link"; it is astrounding that the country with the currency, most often used to finance international transactions, is most severely limited in the efficiency that it can offer in financial services.

Mr. Chairman, you know where I stand. I believe that the sooner we can put together legislation, the better. We have to get back in the marketplace before it is too late.

Gentlemen, thank you for your appearance here today. I look forward to your testimony.

The CHAIRMAN. Thank you very much, Senator Shelby.

As is our practice, as other members arrive and we reach an appropriate point where it fits in, I will also call on them for opening comments that they wish to make.

By discussion and agreement, we have decided to go in the alphabetic order of the institutions that you each represent with that being agreeable to each of the three of you.

So Mr. Leslie, we will start with you, and we would be very interested in hearing from you at this time.

STATEMENT OF PETER LESLIE, DEPUTY CHAIRMAN, BARCLAYS BANK PLC, LONDON, ENGLAND

Mr. **Leslie**. Good morning, Mr. Chairman and Senators. I am Peter Leslie, Deputy Chairman of Barclays and also to some very small extent a regulator, since I am also a member of our official Board of Banking Supervision and was earlier a member of our United Kingdom Deposit Protection Board.

Your invitation was addressed to Sir John Quinton, our Chairman, but he is regrettably unable to be here because he is having by-pass surgery from which he is now recovering and he will be shortly back and well, but he asks to be excused today and to send you his very best wishes.

The **Chairman**. Well, please take our good wishes to him and our hopes that his recovery will go splendidly.

Mr. **Leslie**. Thank you, Mr. Chairman. In the very short time available, I just wanted to say a few words underlining some of the points that we have made in our written evidence.

First of all, Barclays itself, is the largest and most profitable banking group in the United Kingdom, but not just another foreign bank. We are actually celebrating our Centenary here in the United States this summer.

We are represented in over 70 countries around the world including every member of the European community. We are also very much a global bank with a diversified business which includes commercial and investment banking, securities and insurance, leasing and factoring, credit cards and mutual funds, just to name the main ones.

So, we are a money center bank, an investment bank, a community bank and a thrift rolled into one, certainly a British universal bank.

Now, of course, from that list of activities, you will realize that banks are permitted to do a very wide range of things. In fact, permitted is actually in the United Kingdom the wrong word, because the law is largely silent on the matter.

There are only two explicit prohibitions on activities which a bank can do. One is life insurance underwriting and the second is mutual fund management. And, neither of these are in the banking legislation, but each of them can be undertaken through a subsidiary of the bank. And, that is the route that most United Kingdom banks have followed.

The flexibility that the law allows covers a number of areas which will be of interest to the committee. In particular, there is no separation between commercial banking and investment banking. Indeed, our securities and investment banking arm, BZW, which is whollyowned by Barclays, is a market leader in the London market and is developing an effective global presence.

Independence of action is still highly prized within the group and the links have not prevented BZW's investment analysts advising clients to sell Barclays shares on some occasions.

There is no pre-judgment on the legal structures. Market participants are free to use their commercial judgments to select the corporate structure that best suits their strategy, target customers and markets and world view, rather than complying with a structure that is enforced by the authorities.

There are no prohibitions on common directorships or personnel sharing between a commercial bank and its subsidiaries, whether these be in securities, investment banking or insurance. We would say that investment in our investment banking and financial services subsidiaries is too important to our long term strategy for the bank not to have oversight and input or to receive input from them.

And, indeed, the Chairman of our investment bank is a fellow Deputy Chairman of the bank with me.

And, finally there are no firewalls between companies. Indeed, the philosophy of the United Kingdom is rather different from the United States in this area, as I shall mention later when considering the question of safety nets.

There is, however, no history of the extent of banking and commerce links enjoyed by my colleague from Deutsche Bank. And, I don't think there is any likelihood in the United Kingdom that this will develop in the near future.

In the area of regulation, the United Kingdom also differs from the United States, in that statutory bank regulation is relatively new. It was only introduced some 11 years ago. And, even so, the United Kingdom is less reliant than other major markets on an array of mandatory rules for its banking supervision.

The British view is that such rules tend to inhibit diversity and thus risk spreading. They can also be cumbersome, especially when the market is undergoing rapid change.

So, the regulatory environment is one of controlled practitioner regulation which results in a more pragmatic approach and is better able to cope with diversity. The supervisor, in our case the Bank of England, whilst working within a common framework, can work on a case-by-case basis.

Whilst the lack of explicit rules and requirements may appear to make the regime too imprecise, we would argue that it places responsibility for safety and prudence firmly where it lies; that is, with the managements of the banks in the market. A healthy degree of uncertainty about the detailed rules prompts them to undertake their own risk assessments and avoids the temptation, when faced with over-comprehensive regulation, of being guided by that rather than market realities; as we say, the tendency to do what is inspected rather than what is expected.

This makes two things imperative for the British system to operate effectively. First, there must be appropriate assessments undertaken on a person's competence, prudence and integrity before they can hold a position of responsibility in the industry. This is the fit and proper test that underpins the authorization process of the bank and the Securities and Investment Board for banking and investment services, respectively.

That authorization can, and is, withdrawn at any time and represents a very effective sanction for the regulator.

Second, there must be appropriate assessments of the individual banks' controls and systems. The supervisor must be confident that the management have the information to manage their own business and that reports are accurate and reliable.

This is undertaken by a special relationship between the Bank of England and the banks' external reporting accountants, as agreed by the 1987 act.

The wide range of activities that U.K. banks are allowed does lead to overlap between banking and securities regulators, as the system is essentially one of functional regulation. This has been solved really by two developments.

First of all, the Bank of England has, as it has done for many years, been undertaking consolidated supervision, well before the relatively recent EC Directives and Basle agreements. Consequently, when banking groups do expand into other areas, they may become subject to the regulation of those sectors. But, they are always under the overall supervision of the Bank of England.

Second, with the development of statutory regulation of the investment services industry under the 1986 Financial Services Act, the number of regulators has increased. And, the concept of Lead Regulator has been developed to avoid unnecessary duplication, over-burdening bureaucracy and regulatory gaps.

That leads me to the question of the safety net and the subject of firewalls. In the United Kingdom, the safety net is very much aimed at the retail or consumer-customer.

These individual depositors are not deemed to have detailed knowledge of the market to make fully informed judgments on underlying matters such as credit risk. However, the rule of caveat emptor still applies.

They are not completely insulated from the effects of their investment decision as the extent of cover under the Deposit Protection Act is only 75 percent of protected deposits. Both the deposit and investor protection schemes are funded by the industry with no public sector backing.

The schemes do differ from the insurance scheme here, as the powers of the Deposit Protection Board which administers the funds for banks are quite limited. It does not become involved in rescues. It is purely a compensation fund for depositors of failed institutions. And, over the 5 years of its existence, it has handled some 15 cases but only to very modest amounts of money.

From this, you will see that we do not have a no-failure policy. Neither has the Bank of England ever espoused a "too big to fail" policy.

I don't believe in "too big to fail" and we certainly don't run our operations on the assumption that Barclays has any special protection. Indeed, we will go further and say that anyone who did manage their business on that basis is not fit and proper.

Failing is a vital part of the market discipline. Now, there may be some confusion as to what represents failing. It can be a change in which management is replaced or the business restructured while retaining the name. It can be an orderly run-down or sale of viable businesses over time.

Before looking at competitive issues, I shall comment very briefly on the question of firewalls and the differing philosophies. They start, of course, from the common ground that the cost of deposit protection should not be unnecessarily great or be a burden on the taxpayer. And, both recognize the market pressure for diversification.

The system in the United States attempts to minimize the extent of the safety net by setting rigid firewalls between banking and other subsidiaries in the group. It aims to prevent failure in one part of the group spilling over to affect the insured company.

In the United Kingdom, the banks are expected to stand behind their subsidiaries and bank controllers, by which the law means shareholders who are able to exercise influence on the management of the bank, are expected to stand behind their banks. This was exemplified by the Johnson Matthey situation a few years ago.

And, the Bank of England's supervisory powers are extended commensurately. We would say that that recognizes the commercial realities.

Indeed, the United States system with its statutory separations may now act to frustrate the intentions of the original legislation, as it could be argued that it could be both anti-competitive and anti-prudential.

First of all, it restricts financial competition in the United States marketplace by excluding banks from investment business when there are overlaps in terms of satisfying customers' needs.

Second, by restricting capital by marketplace, it constrains activities within financial markets and reduces capital available to support businesses' needs.

Third, restrictive regulation reduces domestic market growth as business tends to migrate to the freer markets developing elsewhere. And, the Euro-markets' developments in the 1970's in Europe are very much a case.

Fourth, regulation reduces the flexibility of U.S. financial institutions to respond to change.

Disintermediation, by which I mean the practice of by-passing the banking system by large commercial borrowers, eats into the quality of commercial banks' asset bases as the best credits can raise their funds direct from investors. This is compounded by the banks' lender of last resort function in supplying line backing for the issues.

And, of course, enforced geographic specialization inhibits the ability of banks to withstand market shocks in local economies.

And, these limitations in our view do not sit comfortably alongside the changes that are taking place in the global financial services industry or in Europe.

The Second Banking Directive of the EC and the related legislation is, indeed, based on a framework for universal banking. But, I don't think we are going to see any one model developing in the immediate future. The national markets are still much too disparate for that.

But, nonetheless, the Single Banking Passport, as it has been called, will be a reality. It will enable banks to set up offices or sell financial services right away across the community.

And, indeed, the globalization of the financial services market could well extend that competition beyond the community itself.

We are also, of course, seeing the increasing interdependence between banking and insurance, as in many cases they meet similar customers' needs.

We are also seeing very strong competition from within the—from outside the financial services industry with non-banks moving into traditional banking markets. The extension of credit cards issued by retailers and credit corporations of various large groups immediately spring to mind.

So, financial markets, to conclude, are already global markets. We undertake currency trading 24 hours of the day through our network of global dealing centers in London, New York and Tokyo.

The stock of major world class companies is already traded in markets worldwide. The changes in Europe and those on the horizon in Japan continue that trend of liberalization in the financial markets, which are notoriously mobile.

The United States has a long history of active involvement in all these markets. And, both it and the world are better for that.

With the increasing integration and interrelation of financial markets globally, we are obviously concerned that there should be no weak links in the major economies underpinning those markets. And, therefore, we would welcome an updating of the banking regulations here to enable the United States to continue to play its full and rightful role in the system.

We are sure that not only the banks but also their customers and the economies of the world at large stand to benefit.

But, perhaps I could make one observation to conclude by turning the usual premise of capitalism on its head, for in the sphere of regulation, more is not necessarily better than less.

Mr. Chairman, thank you very much for listening. And, I wish your colleagues and you yourself very well in your efforts.

[The statements of Peter E. Leslie follow:]

SUMMARY OF

TESTIMONY BY

PETER E. LESLIE

DEPUTY CHAIRMAN

BARCLAYS PLC AND BARCLAYS BANK PLC

before the

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

June 13, 1990

Good Morning Mr Chairman, Senators.

I am Peter Leslie, Deputy Chairman of Barclays PLC and Barclays Bank PLC. I am also in some sense a regulator, since I am a member of the official Board of Banking Supervision and was earlier a member of the U.K. Deposit Protection Board.

Your invitation was addressed to Sir John Quinton, our Chairman, but he is unable to be here as he is recovering from heart by-pass surgery, which I am pleased to say was entirely successful. He sends his good wishes.

In the short time available to me now, I shall highlight the main points of our detailed formal statement which we have submitted. I cannot attempt to cover all the ground of that statement in 10 minutes.

I should like to start by introducing Barclays to you. We are the largest and most profitable banking group in the United Kingdom, but we are not just another "foreign bank". This year marks 100 years of Barclays in the United States. We are represented in over 70 countries across the world including every member state of the European Community. We are also a unique global bank with a diversified business which includes commercial and investment banking, securities and insurance, leasing and factoring, credit cards and mutual funds to name but a few. We are a money center bank, investment bank, community bank and thrift rolled into one - certainly a British universal bank.

From this you will realize that the list of activities that banks are permitted in the United Kingdom is potentially quite long. In fact, permitted is almost the wrong word as statute law is largely silent on the matter. There are only two explicit prohibitions on activities that a bank can undertake directly - life assurance underwriting and mutual fund management - and neither of these are in banking legislation. Even these activities can be undertaken through a subsidiary of the bank, which is the route that we have adopted.

The flexibility that the law allows covers a number of areas that will be of interest to the Committee. In particular,

- there is no separation between commercial banking and investment banking. Indeed, our securities and investment banking arm, BZW, which is owned by Barclays Bank PLC, is a market leader in the London market and is developing a forceful global presence. Independence of action is still highly prized within the group and the links have not prevented BZW's investment analysts advising clients to sell Barclays shares on occasion.

- there is no pre-judgement on the legal structures. Market participants are free to use their commercial judgement to select the corporate structure that best suits their strategy, target customers and markets and world view, rather than complying with a structure enforced by the authorities.

- there are no prohibitions on common directorships or personnel sharing between a commercial bank and its subsidiaries, whether these be in securities, investment banking or insurance. We would say that the investment in our investment banking and financial services subsidiaries is too important to our long term strategy for the bank not to have oversight and input or to receive input from them. You may know that Sir Martin Jacomb, the Chairman of BZW is also a Deputy Chairman of Barclays Bank.

- finally there are no firewalls between companies, indeed, the philosophy in the UK is rather different from the U.S. in this area, but I shall mention that later when considering the safety net.

There is, however, no history of the extent of banking and commerce links enjoyed by my colleague from Deutsche Bank, and I do not think that there is any likelihood of them developing in the UK in the immediate future. The market conditions are different, not least in terms of concentration. We are concerned that there would be too many conflicts of interest.

In the area of regulation, the UK also differs from the U.S., in that statutory bank regulation is relatively new - only being introduced some 11 years ago. Even so, the UK is less reliant than other major markets on an array of mandatory rules for its banking supervision. The British view is that such rules tend to inhibit diversity and thus risk spreading. They can also be cumbersome, especially when the market is undergoing rapid change. The regulatory environment is one of controlled practitioner regulation, which results in a more pragmatic approach and is better able to cope with diversity. The supervisor, in our case the Bank of England, whilst working within a common framework, can work on a case by case basis.

Whilst the lack of explicit rules and requirements may appear to make the regime too imprecise, we would argue that it places responsibility for safety and prudence firmly where it lies - with the management of the banks in the market. A healthy degree of uncertainty about the detailed rules prompts them to undertake their own risk assessments. It avoids the temptation, when faced with over-comprehensive regulation, of being guided by that rather than market realities; as we say, the tendency to do what is inspected rather than what is expected.

This makes two things imperative for the British system to operate effectively. First, there must be the appropriate assessments undertaken on a person's competence, prudence and integrity before they can hold a position of responsibility in the industry. This is the "fit and proper" test that underpins the authorization process of the Bank and the Securities and Investments Board for banking and investment services respectively. That authorization can be withdrawn at any time and represents a significant sanction for the regulator. Second, there must be appropriate assessments of the individual banks' controls and systems. The supervisor must be confident that the management have the information to manage their own business and that the reports are accurate and reliable. This is undertaken by a special relationship between the Bank of England and the bank's external reporting accountants, granted by the 1987 Banking Act.

The wide range of activities that UK banks are allowed does lead to overlap between banking and securities regulators, as the system is essentially one of functional regulation. This has been solved by two developments. First, the Bank of England has been undertaking consolidated supervision for some years, well before the relatively recent EC Directives and Basle agreements. Consequently, when banking groups do expand into other areas they may become subject to the regulations of those sectors, but they are always under the over-arching supervision of the Bank of England. Second, with the development of statutory regulation of the investment services industry under the 1986 Financial Services Act, the number of regulators has increased. The concept of Lead Regulator has been developed to avoid unnecessary duplication, over-burdening bureaucracy and regulatory gaps, where everyone assumed that the supervision had been undertaken by someone else.

This leads me to the operation of the safety net and the subject of firewalls, which has been a topic of some debate recently. In the UK, the safety net is aimed at the retail, or consumer, customer. These individual depositors are not deemed to have detailed knowledge of the market to make fully informed judgements on underlying matters such as credit risk. However, caveat emptor still applies. They are not completely insulated from the effects of their investment decision as the extent of cover by the Deposit Protection Fund is 75% of protected deposits. Both the deposit and investor protection schemes are funded by the industry with no public sector backing.

The deposit protection scheme in the UK differs from the insurance system here as the powers of the Deposit Protection Board, which administers the Fund, are quite limited. It does not become involved in rescues. It is purely a compensation fund for depositors of failed institutions, and it had handled some 15 cases in its first five years of operation.

From this you will see that we do not have a "no-failure" policy. Neither has the Bank of England ever espoused a "too big to fail" policy. I do not believe in "too big to fail" and we certainly do not run our operations on the assumption that Barclays has some special protection. Indeed, we would go further and say that anyone who did manage their business on that basis is not "fit and proper". Failing is a vital part of market discipline. There may be some confusion as to what represents "failing". Failing can be a change in which management is replaced or the business restructured while retaining the name. It can be an orderly run-down or sale of viable businesses over time. This must be preferable to failing as a disorderly collapse which serves no purpose.

Before looking at competitive issues, I shall comment briefly on the question of firewalls and the differing philosophies in our countries. They start from common ground. Both countries share the concern that the cost of deposit protection should not be unnecessarily great or be a burden on the taxpayer. Both recognize the market pressure for diversification.

The system in the United States attempts to minimize the extent of the safety net, by setting up rigid firewalls between banking and other subsidiaries in a group. It aims to prevent failure in one part of the group spilling over to affect the insured company. In the UK, we have formed a view that confidence in a bank is related to its name and extends to its associates. Banks are expected to stand behind their subsidiaries and bank controllers (by which the law means shareholders who are able to exercise influence on the management of the bank) are expected to stand behind their banks. This was exemplified by the Johnson Matthey situation. The Bank of England's supervisory powers are extended commensurately. We would say that recognizes the commercial realities.

Indeed the U.S. system with its statutory separations may now act to frustrate the intentions of the original legislation, as it could be argued to be both anti-competitive and anti-prudential.

First, it restricts financial competition in the U.S. market place by excluding banks from investment business, when there are overlaps in terms of satisfying customer needs. Consequently neither U.S. Commercial Banks nor U.S. Securities Houses are able to compete with their overseas banking competitors across the full product range. Customers are not necessarily getting the best service or terms. In the longer term, the commercial viability of U.S. participants in the market will be weakened.

Second, by restricting capital by marketplace, it constrains activities within financial markets and reduces capital available to support businesses' needs. The barriers to the free flow of capital between markets potentially lead to a distortion in the allocation of capital. Consequently, prices to customers could be artificially high in some markets and artificially low in others.

Third, restrictive regulation reduces domestic market growth as business tends to migrate to the freer markets developing in Europe. The development of the Euro-markets in the seventies and eighties is a prime example of this. The U.S. could lose the ability to be the place where the major capital transactions happen.

Fourth, the regulations reduce the flexibility of U.S. financial institutions to respond to change. If I may carry the football analogy in my written submission further, whilst only having a running game may not lose you every match, it certainly lowers your chances of making the Superbowl, if the other teams have a full playbook at their disposal.

Disintermediation, by which I mean the practice of by-passing the banking system by large commercial borrowers, eats into the quality of commercial banks' asset bases as the best credits can raise their funds direct from investors. This is compounded by the banks' lender of last resort function in supplying line backing for the issues.

Enforced geographic specialization inhibits the ability of banks to withstand market shocks in local economies.

These limitations on U.S. banks do not sit comfortably alongside the changes taking place in the global financial services industry or in Europe.

The Second Banking Directive and related legislation gives the framework for universal banking, but I do not see any one model developing in the immediate future. The existing national markets are too disparate in character and structure and the players are reacting differently. Taking into account the nine Community languages, 12 legal systems and varying adherence to the spirit, if not the letter, does allow for subtle nuances to develop from what started life as one Directive. But the Single Banking Passport, as it has been called, will be a reality. Banks will be able to set up offices or sell financial services across the European Community under the supervision of their home country banking supervisor. Undoubtedly anomalies will arise. Sir Leon Brittan commented recently in Washington, that unified markets

"provide a climate which is conducive to innovation, product deregulation and even a degree of legitimate competition between regulatory structures".

The globalization of the financial services markets could well extend that competition beyond the European Community.

The situation is further complicated by the increasing interdependence between banking and insurance as in many instances they meet similar customer needs. The Allfinanz concept is already well established in Germany, with most banks having links with life assurance companies. We are also seeing insurance companies making alliances of their own. Allianz, Europe's largest insurance company has recently made some interesting moves in this respect.

Not only are the banks facing increased competition from within the financial services industry, but non-banks are also moving into traditional banking markets. Banking is notoriously difficult to define; even dictionaries give up the fight. To them banking is that business undertaken by bankers. Bankers meanwhile are those who undertake banking. Even so, there are an increasing number of businesses that would certainly pass the "duck test", yet do not labor under the same regulatory regime. The extension of credit cards issued by retailers and the "credit corporations" of various large groups spring immediately to mind.

Information technology is changing the economics and means of competition making old definitions obsolete. The banking and financial services industries must be allowed to respond to the changes. It is impossible to pre-judge what is the best solution or structure. The competition in a market already showing signs of over-capacity will determine the result. We believe that the universal bank providing a wide range of products into focused market sectors is the most effective means of delivering financial services. The regulatory environment must be able to cope with the transition without artificially deciding the outcome.

CONCLUSION

Financial markets are already global markets. We undertake currency trading 24 hours a day through our network of global dealing centers in London, New York, and Tokyo. The stock of major world class companies is already traded in markets worldwide. The changes in Europe and those on the horizon in Japan continue the trend of liberalization in the financial markets, which are notoriously mobile.

The United States has a long history of active involvement in all these markets and both it and the world are better for that. With the increasing integration and interrelation of financial markets globally, we are obviously concerned that there should be no weak links in the major economies underpinning those markets. Therefore we would welcome an updating of the banking regulations here to enable the United States to continue to play a full role in the system. We are sure that not only the banks but also their customers and the economy at large stand to benefit.

But perhaps I could make one observation to conclude, by turning the usual premise of capitalism on its head, for in the sphere of regulation, more is not necessarily better than less.

Mr Chairman, I thank you for listening and wish you and your colleagues well in your efforts.

STATEMENT (WITH APPENDICES)

BY

PETER E. LESLIE

DEPUTY CHAIRMAN

BARCLAYS PLC AND BARCLAYS BANK PLC

BEFORE THE

UNITED STATES SENATE COMMITTEE
ON

BANKING, HOUSING AND URBAN AFFAIRS

JUNE 13TH, 1990

Good Morning Mr Chairman, Senators.

I am Peter Leslie, Deputy Chairman of Barclays PLC and Barclays Bank PLC, and am presenting this evidence before you in the place of our Chairman, Sir John Quinton, to whom your invitation was addressed. He is currently convalescing after heart by-pass surgery, which I am pleased to say was entirely successful.

I am also in some sense a regulator, since I am a member of the official Board of Banking Supervision and was earlier a member of the U.K. Deposit Protection Board.

INTRODUCTION

Your invitation sought testimony regarding the financial services regulatory apparatus in the United Kingdom, looking for comment in four primary areas:

1. The range of permitted activities for banking organizations and the appropriate corporate structure;
2. The bank and financial regulatory and supervisory apparatus in the United Kingdom and the United States, with reference to the impact on banks' relative competitiveness;
3. The operation of the safety net arrangements for financially troubled institutions;
4. The future evolution of the global financial services industry with specific reference to Europe after 1992.

In this formal statement, and the Appendices submitted herewith, we seek to address these issues without, however, attempting to be over-prescriptive in our conclusions. We have restricted ourselves to description of the system in the United Kingdom and comparisons with the regime here, highlighting the major differences and the implications of these.

THE BARCLAYS BANK GROUP

Perhaps I can preface my remarks by giving some background to the Barclays Bank Group, to explain the context within which our views have been formulated. Barclays PLC, with its principal operating subsidiary, Barclays Bank PLC, is the largest and most profitable banking group based in the United Kingdom. From a U.S. perspective, however, we think of ourselves as something rather different from being just another "foreign bank." We are here for the long term. In 1990 we celebrate the first 100 years of our operations in the United States and nearly 300 years of Barclays banking at the site of our Lombard Street Head Office in London.

We also consider ourselves to be rather more than just a bank, for we have a very diversified business across financial services, including commercial and investment banking, securities, insurance, credit cards, leasing, factoring and mutual funds, to name but a few.

At Barclays, we believe that any company has responsibilities not only to its shareholders, but also to its customers, staff, suppliers and the communities in which it operates. We are a commercial organization whose raison d'être is to generate wealth not only for the benefit of our stockholders, but also for our customers and the communities in which we do our business. Inevitably these responsibilities can produce the need to resolve short-term conflicts of interest between these groups, but at all times we aim to act in the long-term best interests of the greatest number.

The Barclays Bank Group is represented in over 70 countries worldwide, including all the member states of the European Community, with over 4,000 offices throughout the world. Some two-thirds of these are in the United Kingdom, so we could be described as a community bank. At the same time, we are the most active in the London foreign exchange markets, which themselves are the largest in the world, and major participants in the international banking scene, so we could equally be described as a money center bank.

Our investment banking arm, Barclays de Zoete Wedd, is in the top three in the London equity markets, internationally deals on 24 stock exchanges and has an internationally regarded research operation covering 2,000 companies in 21 countries. To bring a final contrast, we have some $13 billion of lending as mortgages to home owners in the United Kingdom, so you could say that we are Britain's seventh largest savings and loan institution.

Barclays is a unique global bank. In spite of our breadth of products and services, we do not aspire to being "all things to all people" and our approach to our various markets is very focused.

I shall return to that theme in considering the fourth of your questions regarding future developments in the financial markets of the European Community and the likelihood of convergence within the EC on one banking model - the so-called universal bank. If this does become the case, it will be as a result of responding to market forces following a facilitating, but not enforcing, legislative framework.

THE POWERS OF BANKING ORGANIZATIONS

May I turn first, however, to the question of activities permitted to a banking group within the United Kingdom. As you will have gathered from my description of our own activities, the list is potentially quite long, but I have to say that British statute law is largely silent on the matter, which makes it rather difficult to make the sort of definitive comparisons that you may be seeking. I can really only comment on the present situation, which, as you will have heard many tell you, is currently undergoing a great deal of change. (I have provided details of the appropriate legislation in the first Appendix with this statement.)

A. Restrictions on Direct Bank Activities

There are no statutory prohibitions as to which activities a bank can carry on in the United Kingdom, whether directly or via a subsidiary, except that:

1. A bank cannot act as a Life Assurance company directly.

   Such companies are authorized under the Insurance Companies Act of 1982 and are not permitted to carry on any other activity, except those allowed under that Act. However, Life Assurance companies can operate as subsidiaries of banks and, indeed, our own Life company, Barclays Life Assurance Company Limited, was established for that reason.

2. A bank cannot act as a manager of an Authorized Unit Trust (Mutual Fund), under Section 83 of the Financial Services Act.

   Again, this activity can be undertaken through a subsidiary, in our case Barclays Unicorn.

As a result of the flexibility allowed in the law, the financial services industry has developed in response to market needs. Its ability to respond to change has made the City of London one of the pre-eminent Financial Centers in the World.

B. The U.K. Banking Scene

The UK domestic banking system is dominated by the "clearing banks", so-called because they historically have provided the country's payment clearing system and are the members of the Bankers' Clearing House. Their principal source of revenue and profits is their extensive networks of branches throughout the United Kingdom. These provide retail banking services to both corporate and personal customers and act as distribution networks for a wide range of financial services including insurance, travel services, selling of unit trust and stock exchange securities and credit card products. The Clearing Banks have developed over time into complex financial services groups, which could be described as "universal banks".

If I may give you an indication of the variety that can produce, Lloyds Bank owns and operates a chain of real estate agencies in addition to its branch network, which gives it additional opportunities for sales of mortgages and insurance products. The other banks have eschewed that strategy. The National Westminster Bank has a significant computer bureau subsidiary and Midland Bank owns a large Travel Agency - Thomas Cook.

Rather more prosaically, Barclays includes in its portfolio of companies a small chain of garages, which aids sales of automobile finance, as well as obtaining attractive discounts on the fleet of some 4,600 automobiles that the bank provides certain of its management staff as part of their remuneration packages. We also have a small, but successful automobile and truck fleet management subsidiary. These are trivial examples, but they do show the extent of the diversity that you will find in the United Kingdom "banking" scene.

C. Commerce and Banking

Before the specter of commerce and banking links in the UK rises too high, I ought to point out that these represent an insignificant part of the totality and their history goes back some way, as an early forerunner of the cross-selling that the likes of Ford and General Motors achieve on a rather larger scale and from the other direction.

There is no history of the sort of bank/commerce linkages that you see, for example, in Germany and I do not expect them to develop in the immediately foreseeable future.

Because of the concentration of the United Kingdom banking market, such extensive links would not be feasible. There would be too many conflicts of interest. That is not to say that we do not aim to develop close relationships with our customers, but these are dependent on providing consistent good quality service based on a detailed understanding of the client's needs. The banking/commerce links in Germany certainly act as a barrier to entry to banking in that market, but the benefits of such relationships for the various parties are a matter for debate and not something we would comment on in detail.

D. Investment Banking Activities

In addition to their retail activities, the commercial bank groups may also undertake investment banking, such as mergers and acquisitions, and securities activities in both the debt and equity markets, including sales and underwriting, investment advice and analysis, portfolio and trust management. These are usually, but not necessarily, located in separate subsidiaries, primarily for historical reasons, but also because in all these activities, independence of advice is a prerequisite and this can be seen to be provided through a separate subsidiary rather more easily. The banks are free to make the structural decisions that best fit their respective market places - and also change this when circumstances change. In our own group this independence is highly prized, and, as Sir John mentioned in his evidence to the House Energy and Commerce Sub-Committee on Telecommunications and Finance in 1987, has in the past extended to our Investment Analysts advising our shareholders to sell Barclays on occasion.

As I mentioned earlier, apart from the question of life assurance and unit trust management, the statute law makes no specific prohibitions or prejudgements as to the appropriate structure for a banking group. The UK banks are therefore free to develop the structures that best suit their strategy, markets, culture and world view. These structures also undergo change to meet changing circumstances, either internally or externally. It is equally true to say that the functional management and organization structures do not necessarily correspond to the legal shareholdings.

E. Barclays' Structure

Consequently, it is not possible to give a definitive statement on what is the structure of a UK banking group. Indeed, over the last 10 years or so, we have seen the major clearing bank groups develop from a point where the investment analysts found it difficult to find any major differences between the groups, to one where it is becoming increasingly difficult to find similarities. This is especially true in the period since "Big Bang" in London, as the banks adopted different strategies and have had quite markedly different degrees of success. Whilst this has produced diversity on legal structures, the regulators have powers equivalent to the task. The corporate structure is flexible and subsidiaries can relate to one another freely.

The Bank of England's regulations extend beyond the regulated institution itself, as the Bank of England has been undertaking consolidated supervision for a number of years now, well before the publication of the European Consolidated Supervision Directive and the Basle agreement on capital adequacy standards. So when banking groups expand into other areas they may become subject to the regulations of those sectors, but always they are under the over-arching supervision of the Bank of England.

Barclays is acknowledged to have had a notable success in the post "Big Bang" environment with the Barclays de Zoete Wedd investment banking arm (BZW). However, this success is not based on the success of BZW alone, but also on the synergies between its operations and that of the commercial banking business. There are a number of joint teams in activities where overlap enables us to eliminate duplication, for example in syndications. In many respects the products of the commercial bank and the investment bank represent a continuum when considered from the point of view of satisfying customer needs and there are a number of products which would be equally at home in a commercial bank or an investment bank. It becomes a management decision as to where those activities are best sited.

The same applies to the management of activities within BZW itself. The Barclays de Zoete Wedd group consists of a holding company, Barclays de Zoete Wedd Holdings Limited, with a number of subsidiaries, all of which (other than those engaged in investment management) are run as an integrated organization. The principal activities in the equities division are market-making and distribution of domestic and international equities, convertible and hybrid issues, margin instruments, futures and options and research in domestic and international equities. In fixed income securities BZW undertakes market-making and distribution of UK Government securities and other domestic sterling bonds, U.S. Government and Federal Agency securities, international debt instruments and swaps, margin instruments, futures and options, the origination and distribution of corporate bond issues and commercial paper programs and research in economics, currencies and bonds. As a merchant bank, it provides corporate finance services for mergers and acquisitions, disposals, privatizations, share incentive schemes, capital raising, equity issues, placings, flotations, equity in the form of development capital, management and employee buy-outs, specialized loan packages, syndications, and off-balance sheet financing. Finally there are also investment management services: fund management for pension funds and other institutional investors, property management for institutional investors.

The Barclays Bank Group also includes Barclays Financial Services Limited (BFS), a holding company which, through its subsidiaries, provides a comprehensive range of corporate and personal financial services including investment management, financial planning, executorship and trust administration, personal taxation, management of unit trusts (mutual funds), insurance broking, life assurance, pensions fund advice and pensions underwriting. The sales of these products are undertaken independently by employees of BFS and also through the bank's branch network in the UK.

The boards of both BZW and BFS include Directors from Barclays Bank PLC. The investments that we have made in these companies and their place in our future strategy are too important for the Bank not to have an input to and oversight of their operations at a senior level. We also encourage regular contacts and secondments of staff at various levels to ensure that our customers receive the right introductions at the right time to the right services of the Group. The financial services industry is changing at an ever faster pace and it is vital for the future success, and therefore safety, of a bank that its people are able to pool their experience and knowledge.

The structure that we at Barclays have adopted, which includes a non-bank holding company as the listed entity, has resulted, at least in part, through an accident of history, when in 1985 we brought together and unified the Group's domestic and international banking arms - which were at that time separate legal entities in a parent-subsidiary relationship, but it does convey certain advantages for the future. Barclays' structure should not therefore be seen as typical, or necessarily everyone's preferred solution. I have included a description of the major elements of our

Group structure as Appendix 2 for reference. It is one of the strengths of the UK's system that banks have the flexibility to respond to changes in the market and to organize their business in the way that best facilitates meeting the needs of their customers, managing the risks in the business and producing the best return for the shareholders.

F. Comparison with the United States

Clearly, this situation differs markedly from that in the United States, where the separation of commercial banking from securities and other business sectors is sharp. Further, in the United Kingdom subsidiaries can all be subsidiaries of the bank, whereas in the United States, the subsidiaries are subsidiaries of the bank holding company, a term which has no special legal meaning in the UK. Subsidiaries of U.S. bank holding companies generally cannot interrelate freely. The separations characteristic of the U.S. system are compounded by the limitations on inter-state banking, which of course do not exist in the United Kingdom and will not exist in the Single European Market.

The U.S. banks seem therefore relatively limited in the financial activities they can undertake domestically and the areas they can serve, when compared to their UK competitors. Whilst these measures were appropriate for the time they were devised, it could be argued they now operate to frustrate the objectives of the original legislation. Rather than protecting the consumer and financial system from undue concentrations of banks and from excessive risk, they prevent the consumer receiving the benefits of free competition and increase the relative risk of the banks by limiting their ability to respond to changing circumstances. I shall return to this in more detail shortly, but would draw your attention to exhibit 1, which is a comparison of the credit rating of Barclays by one of the major credit rating agencies compared to those of the leading money center banks over recent years, which gives an indication of the relative risk as perceived by the market.

THE BANK AND FINANCIAL REGULATORY AND SUPERVISORY APPARATUS

Having given that introduction I shall now consider our financial regulatory and supervisory apparatus in the United Kingdom. I have set this out in detail in Appendix 1 with this submission, but have not included the relevant Acts of Parliament themselves. I have also included outline comparisons of regulatory reporting requirements as they affect banks in the UK, U.S., France and Germany at Appendix 3.

Banks in the United Kingdom are generally supervised on a functional, rather than an institutional basis. They do not, however, face the statutory impediments to transacting securities business inherent in the United States and Japan. This means that although we can undertake a wider range of activities, we also have to meet the requirements of a number of regulators, although the ultimate regulatory authority for the Barclays Group is the Bank of England.

A. The Development of the Regulatory System

The statutory regulation of banks is fairly new to the United Kingdom, having been introduced only some 10 years ago. The present arrangements were preceded by what Sir John Quinton has described as "a mixture of law, club rules and custom" and has been replaced by what he called "controlled practitioner regulation".

The "secondary banking crisis" in the early 1970s underlined the need for a more coherent framework, supported by statutory powers. The Banking Act of 1979 was the first step in providing the framework, addressing the issue of funding sources that had precipitated the problems in the unregulated sector, by extending the regulatory net but still preserving a two-tier structure in the form of recognized banks and licensed deposit takers. The Johnson Matthey affair of 1984 arose in part from the weaknesses of management and the regulation on the asset side of the balance sheet. It prompted the reforms of the 1987 Banking Act, which provides the current statutory authorization of deposit-taking institutions, except Building Societies - the equivalent of your thrift institutions - and Credit Unions, which have their own separate legislation and regulatory framework.

Despite the statutory nature of the 1987 Act, the United Kingdom continues to be less reliant than other markets on an array of mandatory rules for its banking supervision; they tend to inhibit diversity - and thus risk spreading - and to be cumbersome in a rapidly changing market place. The UK regulatory environment for banks is one that is characterized by a powerful supervisor, the Bank of England, having statutory powers to back flexible interpretation of the regulation that suits the changing market place. It also enables the Bank rapidly to develop new guidelines, after appropriate consultation, for new products and situations as they develop, assisted by the Board of Banking Supervision, which includes, inter alia, experienced senior commercial bankers.

This is in contrast to the Investment Regulation under the Financial Services Act of 1986, which has been criticized for its rigidity and cumbersome bureaucracy. This is being vigorously addressed at the present time by the Securities and Investments Board under its current Chairman.

B. Regulation and Responsibility

Some may argue that this is too imprecise a regime and that the firms in the market are unable to predict exactly how the supervisory rules work. We believe that this is not the case and rather that a healthy degree of uncertainty in this respect prompts the management to ensure that their business is run properly and safely. There is a temptation, when faced with over-comprehensive regulation, to be guided by the regulation rather than make one's own risk assessments. As we would say, "one tends to do what is inspected, not what is expected." Better that the regulatory framework provides the regulator with the right powers to act when necessary, but not to give too much of the detail in advance. It is the duty of bank management to manage - and accept the consequences. This applies equally to regulation - the system in the United Kingdom is highly dependent on self-regulation - and thus the first checkpoint in the regulatory process is the Senior Executives of the Bank.

Recognizing this, the 1987 Act included important provisions for the Bank of England to have direct access to the reporting accountants, which are the external Certified Public Accountants, of each bank to commission specific investigations into controls and checks, such as large exposures as in 1989, certifying the accuracy of returns to the Bank of England and having trilateral meetings between the accountants, the Banking Supervision Division and the management of the individual banks. Self-regulation requires that the systems be in place for the management to keep their own house in order.

C. The "Fit and Proper" Test

Although other countries, such as the United States, have tests of appropriateness, a particular feature of the British system is the rigor with which the Bank of England uses its power to determine who is "fit and proper" to be involved in the financial services industry of the United Kingdom, whether directly or as "controllers" of financial services and banking groups. The test is applied before someone is allowed to have a position of responsibility in a banking group and continually thereafter and includes background checks and detailed questionnaires. The "fit and proper" test is also applied by the Securities and Investments Board to those wishing to undertake investment business in the UK.

The seeming imprecision of the explicit regulation is counterbalanced by the severity of the price of transgression. Great flexibility is given to the players in the market, but the responsibility is equally great. Quite simply, if an individual is found not to be "fit and proper", he, or she, will never work in a position of responsibility in the London financial markets again. Fit and proper is not simply concerned with actual wrongdoing, but to questions of competence, probity, integrity; to errors of commission and of omission. This is especially important when considering the questions of safety and soundness of a banking group and the whole system.

The players in the markets which make up the system share responsibility for the safety of the whole system, which we consider applies equally to confidence as to actual failure. The major players, for example the Clearing Banks, have a particularly close identification with that ethos. This is, however, more a question related to the operation of "safety nets" and I shall therefore return to this point later in this submission.

D. Securities and Banking Regulation: Principles and Practice

There is a commonality of purpose among financial services' regulators, which is to provide security to customers and confidence in the system, whilst not stifling competitiveness.

Failures of securities houses do not lead, of themselves, to a breakdown in the banking system. However, because banks' exposure to the securities industry worldwide is large, when a major securities house fails it can have a damaging effect on the banking system.

It is necessary therefore to manage the risks in the banking system so that they do not exceed an acceptable level. We believe that the system in the UK represents one practical way of ensuring that banking and securities regulation run in harmony.

The people running and controlling banks and securities houses are required to show that they are indeed 'fit and proper' as defined by the respective supervisors, including the Bank of England, which is the ultimate regulatory authority for the Barclays Bank Group. Matters relating to banking codes of conduct are generally dealt with by the banking supervisor, matters relating to sales practice rules in securities houses are dealt with by the securities regulator. The obvious overlap in the area of financial soundness and capital adequacy has resulted in agreements between the banking supervisor and securities regulators covering jurisdiction, reporting and information exchanges. The concept of "Lead Regulator", described in more detail in Appendix 1, is important in this context, as it avoids unnecessary duplication, over-burdening bureaucracy and regulatory gaps.

In terms of systemic risk, the main area of regulatory concern is exposure to sectors, countries and corporations. It is essential that the supervisors collaborate so that they can prevent over-exposure to any one area. This must apply not only to domestic, but also to international supervision.

In both securities and banking regulation more international co-operation is required to promote better worldwide regulation, through the exchange of information, mutual recognition and supervisory convergence. It is almost as if a 'fit and proper' test should be applied to regulatory systems in different countries and the SEC has already taken some tentative steps down the track of foreign regulator reciprocal recognition.

E. Firewalls and Chinese Walls

In the United States, firewalls have been devised to prevent the securities activities of bank holding company subsidiaries from affecting the insured banking subsidiaries. These include strict limitations on capital being moved from the banking subsidiary to the securities subsidiary and on cross-marketing of products, both of which tend to be anti-competitive. Strict limitations of personnel interlocks increase risks as a result of the parent being inadequately informed about the activities of its subsidiary.

I will expand later in this testimony on the question of the extent of the safety net, but it seems appropriate to comment here on the seemingly opposing philosophies on the subject of firewalls between the United States and the United Kingdom. Perhaps I can characterize these as the minimalist and the maximalist approach. Both countries share the concern that the cost of deposit protection should not be unnecessarily great. Both countries also recognize the market pressure for diversification. However, in the United States the approach has been to try to "ring-fence" the insured activities to protect them from external shocks - the "minimalist" approach because it attempts to minimize the extent of the safety net and, thus, regulation. In the United Kingdom, we have formed the view that confidence in a bank is related to its name and extends to its associates, so we have the opposite of firewalls - banks are expected to stand behind their subsidiaries - but the supervisory powers of the Bank of England are extended commensurately - the "maximalist" approach. This, U.S. observers would say, extends the extent of the safety net. We would say that the UK approach pragmatically recognizes the commercial realities of the situation.

In order to protect the interests of the securities houses' clients and to ensure confidence by the clients of both securities houses and the banks it has, of course, been necessary to construct a system of Chinese Walls for the isolation of transactional and client information, but for prudential purposes the paramount necessity is for the bank to spread its risk and to be able to identify, as must the regulators, where over-exposure problems are occurring so that remedial action can be taken. (Chinese walls are arrangements whereby confidential information given to or acquired by one division or an employee thereof is not disclosed or available to another division of a group, or in some circumstances an employee of the same division.)

It is our belief, Mr Chairman, that the UK system, even though it has only been in force for a few years, does work. The major effect that the combination of banking and securities businesses in the UK, and indeed any market where this has happened, has been greatly to increase the amount of capital available to the securities industry. This in turn leads to healthier markets with greater competition and improved client service. Of course there are teething problems and some players may withdraw following the difficulties that inevitably accompany such a change in an industry. But these problems are transitory and do not threaten the system, which in the long term is enhanced because it is only the commercially viable firms that will remain in the market.

F. Regulation and Competitiveness

Having compared regulatory schemes, I now turn to the second part of your question which asked for our views on the impact of your manner of regulation on the competitiveness of United States financial institutions and markets. Perhaps I can again step back and repeat some principles. First, we believe that the best way to promote the competitiveness of an industry or an individual corporation is to expose it to fair competition and that this is best undertaken in the private sector. Second, the interests of customers are best served through competition in free markets. That being the case, we would have to say that the present U.S. system seems to have four adverse effects.

First, it restricts financial competition in the U.S. market place by excluding banks from investment business, when in a number of areas there is major overlap between these sectors in terms of satisfaction of customers' needs. Consequently, neither U.S. Commercial Banks nor U.S. Securities Houses are able to compete with their overseas banking competitors across the complete product range. Customers are not necessarily getting the best service or terms and in the longer term the commercial viability of U.S. participants in the market will be weakened.

Second, because firms are restricted as to the markets in which they may operate, capital is restricted by marketplace as well. This constrains activities within financial markets by reducing the pool of capital readily available to support business needs. The barriers to the free flow of capital between markets potentially lead to a distortion in the allocation of capital. Consequently, prices to customers could be artificially high in some markets and artificially low in others.

Third, the regulations reduce domestic market growth as business tends to move towards the freer markets developing in Europe. If the constraints continue then there is always the possibility of the markets moving offshore, as happened with the rapid development of the Euro-markets in the 1970s. The U.S. could lose the ability to be the place where the major capital transactions happen.

Fourth, the regulations reduce the flexibility of U.S. financial institutions. They deny them the possibility of altering their strategic direction as market conditions themselves change and also reduce their ability to withstand market shocks.

These factors could become more important as the globalization of financial services continues.

G. Does Risk-Averse Regulation Reduce Risk?

All four factors relate to the competitiveness of U.S. financial institutions, but one could also argue that the last has additional implications for the relative risk of the banking sector. It is not unreasonable to suggest that the very regulations designed to limit risk when originally introduced, now operate to increase the relative risk of the banking sector, whether those regulations are limitations on geographic or functional range of operation. It is as though a quarterback had injured his throwing arm in an earlier game and so the trainer tied it behind his back to protect it in this one.

In a number of areas in finance the United States has led the way and several trends that are now becoming prevalent on the international scene had their beginning in the U.S. markets. The first that comes to mind is disintermediation, the practice of by-passing the banking system by large commercial borrowers to obtain their funds. The commercial paper market, for example, has a long history in your country and the maturities that corporations are able to draw through similar processes is lengthening. This eats into the quality of the commercial banking sector's asset base as the better customers draw on investors directly. As a result the relative riskiness of the banks' portfolios increases.

Meanwhile, banks are expected to put in place large committed lines to support the Commercial Paper issues, becoming lenders of the last resort, further compounding the problem. Similar considerations arise in the securitization process. Consequently, an apparently risk-averse regulation could act in the opposite manner. The answer would be to allow the banks to participate in the capital markets and gain the income from those activities to enhance reserves, thereby offsetting the deterioration in the quality of their portfolios.

The second consideration is that of geographical specialization. Clearly commercial banks are subject to the macro-economic cycles affecting their customers, but this effect is unnecessarily accentuated when regional specialization is enforced and the cycles are tied to those of local areas, without the ability to offset reductions in earnings and asset quality, with profits and enhanced assets from other locations. The specialization of the local economy can act to produce asset mixes that would not otherwise be permitted on prudential grounds.

Whilst the first of these considerations affects the general competitiveness and safety of the industry, and the latter only in relative terms, it could be argued that geographic limitations have resulted in definite costs for the taxpayer through the operation of the safety net in this country.

DEPOSITOR PROTECTION, INVESTOR PROTECTION AND THE SAFETY NET

With this in mind, I now turn to the question of the safety net and its operation. You raise particular questions on three related topics:

- depositor protection;

- attitudes towards financially troubled institutions;

and

- "too big to fail" doctrines.

The details of the Deposit Protection Scheme in the United Kingdom are set out in Appendix 4. Schemes designed for the protection of the depositor, or the investor, must answer 2 principal questions: protection of whom and from what?

A. Depositor Protection

The protection schemes in the United Kingdom established initially under the 1979 Banking Act, for depositors, and the 1986 Financial Services Act, for investors, are implicitly aimed at the retail customer, the small investor. They are deemed not to have the detailed knowledge of the market to make fully informed judgements on underlying matters such as credit risk. However, at the same time they are not absolved of the responsibility to make appropriate assessments of the relative risks involved, as the principle of "caveat emptor" still applies, nor are they completely insulated from the effects of their investment decision, underlining the risk/reward relationship.

This is revealed in the degree of protection afforded by the Banking Act legislation; depositors are covered for 75% of protected deposits up to a deposit ceiling of £20,000.

Although the Deposit Protection Scheme was constituted under the 1979 Banking Act the Deposit Protection Board was not established until 1982. To a certain extent the Scheme represents a subsidy of the smaller, riskier institutions by the larger and more stable banks, who pay a larger contribution to the Fund. It does not seem to have attracted the same degree of attention as the equivalent scheme in this country. Up to 1988 it handled about 15 failures, but few know of its activities.

The Board's powers are very limited and it does not, for example, become involved in rescues. It can only act once an institution has been declared insolvent and is thus a compensation mechanism for protecting depositors with failed institutions. It is also prohibited from compensating a depositor who "in the opinion of the Board, has any responsibility for, or may have profited directly or indirectly from, the circumstances giving rise to the institution's financial difficulties."

All institutions authorized under the Banking Act contribute to the Fund based on a percentage of their adjusted sterling deposit base, with the possibility of additional special contributions levied if the Fund is likely to be exhausted before its year end. These special contributions are repaid at the end of the year if they are not needed and if the Fund exceeds L6 million. There are no contributions directly from the public purse, although contributions to the Fund are tax deductible business expenses, so there is a "contribution" from that aspect. Otherwise the Fund is totally self-financing and therefore whilst forming one leg of the safety net does not represent such an overt public subsidy as appears to have been argued in connection with your own system of deposit insurance.

B. Investor Protection

The Investors' Protection Scheme is operated by the Securities and Investments Board. For investors, the degree of protection is 100% of the first £30,000 and 90% of the balance up to £50,000, i.e. a maximum payout of £48,000 which includes interest. There is also a cap on the maximum that can be paid out by the scheme of £100 million in one year. Following a review of the scheme's operation its scope is being extended to cover the investment business activities of the Building Societies (thrifts) and insurance companies.

Payments into the scheme are based on a relatively complex formula based on the size of the firm and the principle that members of the same regulatory body as the failed firms pay the compensation up to a certain figure, above which the balance is shared among all regulated firms. To date there has been a trickle of relatively small failures.

C. The Extent of the Safety Net

There have been various debates about the extent of the safety net as it affects banking groups' "non-banking" activities and the question of firewalls to prevent flows of capital from insured deposits to other activities. The position in the United Kingdom would seem to be at odds with that in this country. In the Report of the Committee set up to consider the System of Banking Supervision of June 1985, which led to the 1987 Banking Act, the question of parental support was directly addressed and, for that reason I take the liberty of quoting verbatim at length:

> "the Bank [of England] has always believed that a bank should stand behind its subsidiaries and other related companies, especially if those companies themselves take deposits. Its view is based on the premise that failure to rescue a subsidiary which got into difficulties would quickly cause a loss of confidence in the parent bank itself. This view is acknowledged and accepted by British banks.
>
> The Bank also believes that owners of banks have an additional responsibility not present in the ownership of most other commercial or industrial undertakings, because of the special fiduciary responsibilities on those who run businesses which take deposits from the public. In the mid-1970s, the Bank began to seek letters of comfort from overseas banks with shareholdings in United Kingdom banks acknowledging their moral responsibility to stand behind the bank should the need arise. Since then this practice has been extended to a wider range of non-bank shareholders from both the United Kingdom and overseas.
>
> ... The Bank believes that it is not necessary to formalize the position [on letters of comfort] in respect of shareholdings by United Kingdom banks because of their agreement that they must stand behind their subsidiaries and other related companies in all but the most exceptional circumstances."

In this context the Banking Supervision Division of the Bank of England was proposing that letters of comfort be obtained from all shareholders who control 15% of the voting power, and 10% in some instances.

D. Consolidated Supervision

The concomitant to that doctrine is that the Regulator should take a close interest in the ability of the givers of those letters of comfort to honor them. This also impinges on the question of consolidated supervision, for if the safety net, in the form of the deposit protection scheme, is there to provide a statutory remedy for loss of regulated deposits, then the regulator should have the appropriate degree of oversight. This creates the need to resolve issues of jurisdiction where functional regulation is in place as is the case in the United Kingdom. As I mentioned before, the concept of "Lead Regulator" has been developed. This avoids the twin pitfalls of unreasonable compliance burdens being placed on the market participants where the duties of regulators overlap and also regulatory "gaps" where everyone assumes someone else is supervising.

If I may quote from a speech given by Mr Brian Quinn, then Assistant Director and Head of Banking Supervision at the Bank of England, in January 1988 to a seminar to study the implications of the 1987 ~~Banking Act:~~

"We [that is the Bank of England] see the need for workable solutions in this area as being a very high priority if the UK is to continue to be an efficient place in which to do business; and we are continuing to devote much energy to getting the framework and the detail right."

E. Financially Troubled Institutions

I have strayed over slightly from the safety net question into the Bank of England's view on financially troubled institutions, so I shall continue on that subject. As you will have gathered from the numbers I mentioned earlier in connection with the Deposit Protection Scheme, we certainly do not have a no-failure policy.

Let me quote Mr Quinn again from the same speech:

"Will the new [1987 Banking] Act prevent bank failures? I think and fervently hope that it will - or more accurately its application will - prevent some that would otherwise have happened. But it most certainly will not prevent all bank failures. More important, nor should it. For failing is a vital part of the market discipline and to seek to prevent it is not only futile, but also misunderstands the function of the supervisor. The Deposit Protection Scheme is an explicit recognition of that proposition. Nevertheless you will understand my sentiments if I conclude with the banking supervisors' benediction: may all your failures be orderly."

It is this approach that underlies the handling of institutions in difficulties. There are a number of questions to be considered in each case, such as the impact on the stability of the market, the possible spill-over effects on other institutions and effects on the international reputation of London as a place to do business. It is not possible to be precise or conclusive about the handling of these situations in advance. It depends upon the circumstances. The objective should be to achieve an orderly run down to get the best long-term result for the most. This can involve the exercise of considerable degrees of patience and also a significant degree of give and take by all parties concerned.

As you will have noted from Mr Quinn's comments, the view in our country is that the responsibility for the safety of the system lies with the participants as overseen by the Bank of England and other supervisory bodies. Some may argue that the greater concentration of the banking market in the United Kingdom permits closer personal relationships that make such informal systems work, but I have to say that successive Chief Executive Officers of our New York based operations have had very good relationships with the Federal Reserve and have never felt any hesitation in calling personally when the need arose.

F. The Safety of the System is a Shared Responsibility

It could be cultural differences which explain the divergent attitudes that seem to be apparent, especially where discussions of the safety net are concerned. That does not mean to say that we do not have occasional differences of view with the Bank of England as to where the appropriate split of responsibilities lies, which is a sign of the strength of the relationship, but we generally agree that the responsibility is joint.

An illustration of this is a comment that Sir John Quinton made in a speech to the Senior Managers' Group in Barclays shortly after the secondary banking crisis of the early 1970s, where he played an active role in the solution:

"Have we been right, in effect, to pay perhaps as much as £10 million as an insurance against loss of confidence in the banking system on the part of our own depositors, and internationally a loss of confidence in the City of London? The answer is one we have brooded over long and often. On balance we feel that we were right to do what we did."

That, of course, does not mean that it would be done again or in that way again. The circumstances of that secondary banking crisis were quite specific and, it has to be said, it was a new experience, hopefully not to be repeated, so that much of the strategy was decided as the situation developed. We believe that this is one of the strengths of the British system. Circumstances change, markets change and expectations change. Both the players and the regulators must have the flexibility also to change.

G. "Too Big to Fail"

Which should bring me on to answering your final question on future developments and trends, but I am conscious that I have not addressed the question that you asked on "too big to fail" doctrines. I do not believe in them and we, at Barclays, do not run our operations believing that we are too big to fail. Anyone who ran their operations on that basis is not, in our view, "a fit and proper person" to hold a position of responsibility in the financial services industry. Further, contrary to what appears to be the impression in some quarters in this country, the Bank of England has never made a statement that any bank is too big to fail. There may be a confusion as to the difference between "failing" as a change in which the management is replaced, a restructuring of the organization while retaining the name, an orderly run down or a sale of viable parts of the business, and "failing" as a disorderly collapse which serves no purpose.

In any case "big" is a relative term and as the globalization, segmentation and expansion of the financial services industry continues in the future, the context in which "big" is determined will change.

FUTURE DEVELOPMENTS

Turning to your final question of the likely course of future developments in the global financial services industry and in Europe after 1992, I hope you will allow me some degree of error in any predictions, as the situation is changing so rapidly, especially in Europe. I am relieved that I am giving this testimony now, rather than 12 months ago, as I do not think that I would care to read now what predictions I might have made about Europe then. I do not think re-unification of Germany and German monetary union would have figured highly, nor would possible extensions of the EC into the countries of Central and Eastern Europe.

A. The Single European Market

Be that as it may, one of the most important single factors facing financial institutions in the 1990s will be the creation of the Single European Market. European markets as a whole will be of a size to challenge the other world leaders, yourselves and Japan.

The Committee will be aware of the Second Banking Directive, which is one of the most important developments arising from the 1992 program. This Directive adopts the principle of home country supervisory control and mutual recognition of each other's supervisory regulations. Banks incorporated in the United Kingdom, for example, whether their parents are British or foreign, will be able to operate throughout the European Community subject to the supervisory control of the Bank of England. Furthermore, they will be able to sell their financial services either across borders or through branches in any other EC state. This, in effect, gives a single banking license for the whole Community, or, as it has been described, a single European "Passport" but, as the term passport indicates, not a single internal market.

Conduct of business rules are for the most part the responsibility of host member states, by which I mean the state in which the branch is operating or where the service is being provided. Similarly, there will not be uniform taxation and in dealing with the nine different languages in the Community and different legal systems, subtle nuances and differences in interpretation can creep in to what started as a single Directive.

B. No immediate Euro-Banking Model

Therefore I have to say that there seems no real likelihood of the European Community legislating a particular banking model in terms of legal structure in the immediate future. Rather the structures adopted by the market participants will be commercially driven in response to the market environment. There may be anomalies as branches of foreign banks could offer products and services that domestic banks cannot because of local regulation - that will be an issue for the local authorities to address - and consumer choice will be widened in the process. There will be differences in effect in different countries and it could be that the banking systems in Southern Europe will feel the effect rather more than the more developed and less protected systems in the north.

Sir Leon Brittan put forward this challenge in his recent speech to the American Enterprise Institute in Washington, when he commented that unified markets "provide a climate which is conducive to innovation, product deregulation and even a degree of legitimate competition between regulatory structures".

Other factors include the different starting points of the national markets and the different strategies being adopted by the participants.

First of all, the present structure of the industry within member states is too disparate and the Single Market does not mean a uniform market. Examples of current differences include the role of the German banks as holders of equity stakes in German industrial and commercial companies, the background of partial government ownership which has, until recently, obtained in other EEC states and the fragmentation of some markets and the concentration of others.

Second, the various players in the markets are reacting in different ways to the challenges presented by 1992. Competitive positioning activities are well under way. Only about ten of the largest European banking groups could contemplate "going it alone". They are now making strategic acquisitions to fill gaps in their product and geographic armory. The most obvious example is Deutsche Bank, with its most recent acquisition being the British merchant bank, Morgan Grenfell. Barclays would see itself as one of those going it alone, but we do not intend planting branches across Europe; the capital and management cost would be prohibitive.

An alternative approach to acquisitions, de novo start-ups, or mergers is the strategic alliance, both within individual countries and across borders. In 1989, we saw several of what have been called "secret pacts" of co-operation which do not show through in the rankings. One of these is Europartners, involving Commerzbank of Germany, Credit Lyonnais of France, Banco Hispano Americano of Spain and Banco di Roma of Italy. Formed in the 1970s, the association has recently firmed up the relationships through a variety of linkages including cross-shareholdings and distribution agreements. As yet there is no British partner. These alliances serve as a defensive measure for the individual partners, allowing them to concentrate resources on their home markets, whilst expanding their geographic presence. They therefore have significant share in the critical "regions" of the Single Market and may represent a formidable force in the future. This has yet to prove to be the case.

C. The Interdependence Between Insurance and Banking

So far I have considered only banking responses to the Single Market, but alliances are not simply being made between banks. This leads me on to another development that you should consider, the growing interdependence, even blurring of the distinctions, between insurance and banking, although insurance is more problematical across national borders as it is more fragmented and legalistic than banking. The "Allfinanz" concept is well established in Germany, with nearly all major banks being linked with life assurance companies through cross-shareholdings, subsidiary companies or distribution agreements. Germany's Allianz is Europe's largest insurance company and has made alliances of its own, with Dresdner Bank and Hypo Bank in Germany, Banque National de Paris in France, and Banco Popular in Spain, as well as with other insurers through Europe. 1989 saw Allianz diversify into banking with a joint distribution agreement with the Dresdner Bank. Dresdner will sell Allianz's insurance products through their network, while Allianz will sell Dresdner's banking products through their 3,800 insurance agents. Allianz has sealed this with a sizeable stake in Dresdner. This move could be construed as a direct response to Deutsche Bank's establishment of its own insurance subsidiary and has certainly hastened the convergence of the two industries in Germany.

With the development of the single market and the competitive pressures introduced by the Second Banking Directive, it is highly likely that the interdependence between insurance and banking will continue to grow, for in many ways they satisfy similar customer needs. It has further to go in the United Kingdom, but the signs are already there with the recent linking of Lloyds Bank and Abbey Life, while we at Barclays have a fast growing Financial Services Division covering Life Assurance, Pensions, Broking and Unit Trusts (Mutual Funds) that produced profits of $270 Million in 1989.

D. Non-bank Competition

I have mentioned some of the strategies adopted by banks and by other financial services groups and I shall also touch on the incursion of non-banks into the banks' traditional markets. Banking is notoriously difficult to define satisfactorily as it is a bundle of different services - indeed in many dictionaries there is the useful circular definition that a banker is someone who does banking, while banking is that business undertaken by bankers.

Information Technology changes the economics of operation and the means of competition. It also changes competitive peer groups making the old definitions obsolete. Many of our competitors are not banks; the services they provide are targeted at our customers and satisfy the same needs as our products. These competitors are not subject to the same regulatory constraints because they do not have banking licenses - yet their activities would surely pass the "duck" test. Provision of credit cards by store groups, the "credit corporations" of various groups spring immediately to mind. With this intensity of competition, it is impossible to say that one model of banking will arise in the future. Indeed, in our view what is more likely is that banks will become increasingly dissimilar as they seek competitive advantage in a fragmenting marketplace.

E. "Universal Banking"

The Second Banking Directive, coupled with the Capital Adequacy Directive and the Investment Services Directive, which is still under discussion, gives a legal framework for "universal banking". The current status of the applicable regulation is enclosed at Appendix 5. Whilst there does appear to be some bias towards an "Allfinanz" type structure, it does not mean that universal banking will be delivered in the same way by different organizations, as I intimated at the beginning of this testimony. In any case universal banking means different things to different nationalities - the German concept of universal banking is rather different from the British. In Britain universal banking refers to product range, in Germany there are also relationship overtones. We believe that the universal bank providing a wide range of services into focused market sectors is the most effective means of delivering financial services. Others may enter with restricted product ranges, perhaps even single product lines, and the regulatory environment must be designed to allow all the structures to develop, for it is not possible to pre-judge what is the "best" solution for every circumstance.

What is certain is that the Single Market developments will not result in a Fortress Europe approach since competition and supervisory co-operation on a global scale will be essential for providing the best service to and protection of customers respectively. One can hardly espouse free-market principles in one's home market and apply different rules in one's international relations. Global competition and co-operation will also be essential for the development of efficient markets which will result in greater liquidity, greater transparency and cheaper transaction costs. This development will be based on strong supervision to ensure the protection of investors, consistent regulation to avoid regulatory arbitrage and a level playing field so as to ensure fair global competition with reciprocity and mutual recognition between major markets.

F. Overcapacity

These future developments do not mean that the banks have a smooth ride ahead, quite the contrary, and it is not unreasonable to expect that we should see some banks disappear, either exiting the market or being taken over. Technological change, involving large investments in Information Technology which change the cost structure by raising the proportion of fixed costs, is rendering volume, and thus market share, important to achieve acceptable returns from financial services. It is not difficult to envisage a developing situation of over-capacity in financial services globally until competition weeds out the under-performers.

There is evidence of this over-capacity already in certain markets and I have included work that some of my colleagues undertook last year to look at just this problem, mainly within the United Kingdom, but the principles hold good. One message to be drawn from this is that as competition intensifies, any financial services company will need to be flexible and able to respond to the challenges to survive.

This may include a focus on a variety of services to meet its customers' needs, or a limited product line to meet a specific niche. In either case, it is surely right for the market to decide what is appropriate, rather than regulation prejudging what is the "best" solution.

CONCLUSION

Financial markets are already global markets. We undertake currency trading 24 hours a day through our network of global dealing centers in London, New York, and Tokyo. The stock of major world class companies is already traded in markets worldwide. The changes in Europe and those on the horizon in Japan continue the trend of liberalization in the financial markets, which are notoriously mobile.

The United States has a long history of active involvement in all these markets and both it and the world are better for that. With the increasing integration and interrelation of financial markets globally, we are obviously concerned that there should be no weak links in the major economies underpinning those markets. Therefore we would welcome an updating of the banking regulations here to enable the United States to continue to play a full role in the system. We are sure that not only the banks but also their customers and the economy at large stand to benefit.

As I think you are learning from the international evidence you are receiving, there are many cultural differences between the existing systems, some where I think you expected them, and some where maybe you did not. The lesson I draw from that is that in updating your framework, you have to take into account your own culture and history and for that reason I have not presumed to be dogmatic about what is "best". But perhaps I could make one observation to conclude, by turning the usual premise of capitalism on its head, for in the sphere of regulation, more is not necessarily better than less.

Mr Chairman, I thank you for listening and wish you and your colleagues well in your efforts to modernize your banking and financial services laws.

APPENDIX 1

SUPERVISION OF THE FINANCIAL SERVICES INDUSTRY IN THE UK

A. BANKS

Unlike most other developed countries, the United Kingdom has had statutory regulation of banks for less than 15 years. Indeed, although the Banking Act 1946 had empowered the Bank of England to issue directions to any banker, it was not certain whether these powers were for supervisory purposes and they were never used in practice.

- Background to the present regime -

The so called "secondary banking" crisis in the early 1970s underlined the need for a more coherent framework, supported by statutory powers. The Banking Act 1979 sought to provide this framework, but it concentrated on the funding sources rather than how these funds were put to use. This shortcoming was exposed by the Johnson Matthey affair in 1984, following which a Committee was set up under the Chairmanship of the Governor of the Bank of England (The Leigh-Pemberton Committee) to review the whole system of banking supervision. The Committee in its report issued in June 1985, made it clear that notwithstanding a good record of Banking Supervision in the UK, compared with the experience of financial centers overseas, there remained some serious weaknesses in the implementation of banking supervision and its statutory framework. The recommendations of the Committee were subsequently incorporated in the Banking Act 1987, which provides the current statutory authorization of deposit-taking business in the UK. Under the Act, the Bank of England (BoE) is responsible for authorizing and supervising all deposit taking institutions except Building Societies and Credit Unions. These are regulated under the Building Societies Act 1986 and the Credit Unions Act 1979 respectively.

- The 1987 Banking Act -

Contrary to the 1979 Act, the BoE now has statutory powers to insist upon the provision of information. Failure to release information and provision of false or misleading information are criminal offenses. In addition, the Bank has been given statutory powers, supported by criminal sanctions, to prevent anyone acquiring a controlling stake in an authorized institution; this is defined as 15% or more of the voting power exercisable at any general meeting of the institution. The 1987 Act also provides for the establishment of a deposit protection scheme and for the control of bank names, descriptions and advertisements. The deposit protection scheme, which ensures that UK depositors with a failed institution will receive 75% of their protected deposits from a fund, with a limit of £20,000 in respect of a protected deposit.

Despite the 1987 Act, the UK system remains less reliant on statutory rules than most other countries. Indeed, the Treasury has argued that detailed statutory prescription can inhibit diversity; one of the strengths of the UK system is that it allows appropriate prudential guidelines to be set for a variety of banks of different sizes. This flexible regime is regarded as an important factor in the growth of London's role as the world's pre-eminent international banking center.

The 1987 Act and the Bank's subsequent statement of principles issued under Section 16 of the Act, provide the BoE with more explicit powers of supervision and investigation than under the 1979 Act and the supervisors are now getting closer to the internal workings of all banks in the UK. Detailed requirements for regulation are not set out in the Act, but as far as possible, are published in a series of consultative documents, notices and guidance notes issued by the Banking Supervision Division.

Schedule 3 of the Act requires a bank to conduct its business in a prudent manner and to maintain adequate liquidity, adequate accounting and other records of its business and adequate systems of control of its business. A bank is required to provide assurances that its internal control systems are reasonable and that the management understands the relationship between manual and computer controls and that particular risks are associated with computer operations.

Every year, each bank is required to provide a reporting accountant's report on any matter agreed between the BoE, the bank and its reporting accountants. As an example, over the last two years, Barclays' Reporting Accountants have produced reports on High Level Controls, and Internal Audit. The function of these reports is to pinpoint any weaknesses in the system so that remedial action can be taken by the bank. The main sources of information on banks available to the Banking Supervision Division (BSD) of the BoE continue to be the regular prudential returns. The reports include operating statements and information concerning lendings analyzed by industry sector and geographical area, and other analyses of sterling and foreign currency assets and deposits, liquidity and capital adequacy, together with operating practices and organizational changes. Banks are also required to report their 20 largest exposures, together with all advances greater than 10% of the capital base (prior approval from the Bank of England is needed for advances in excess of 25% of capital base). The Banking Supervision Division uses these returns to closely monitor the institutions' activities and to conduct periodic interviews with the bank's management.

- **Other Regulations**

Apart from the Banking Act 1987, banking business is also affected by a range of requirements of other statutory and non-statutory bodies, as well as a set of recognized codes of practice established by some business associates. These include:

- Bank of England Grey Paper 1987 on Wholesale Markets Supervision (non-statutory).
- The Securities and Investment Board and the Self Regulatory Organizations (SROs) under the Financial Services Act 1986.
- Recognized Investment Exchanges also under the Financial Services Act 1986.
- Office of Fair Trading under the Consumer Credit Act 1974.
- Data Protection Act under the Data Protection Act 1984.
- Primary capital markets under the Guidance notes issued by the International Primary Markets Association.

B. BUILDING SOCIETIES

- Background -

The first Building Societies were founded towards the end of the 18th century and consisted of about 20-30 members who contributed to a weekly fund which was then used to finance the building of houses for the members. Once all the dwellings had been completed, the society was disbanded. However, by the middle of the last century, Building Societies were becoming permanent institutions borrowing funds from members and lending to people to buy existing houses and financing the construction of new properties.

The post-war period saw a substantial increase in the size of Building Societies. At the end of 1988 (the last available statistics), there were 131 societies with over 6,900 branches and over 43 million individual shareholders (the approximate equivalent of members) whilst total assets stood at £191 billion, compared with only £756m in 1940. However, the two largest societies, Halifax and Abbey National (which converted to a public company in June 1989) accounted for almost 38% of the total assets of the industry.

The balance sheet of building societies is relatively simple with the liabilities side consisting predominantly of shares whilst over 80% of assets are mortgages, with liquid assets accounting for most of the remainder.

- Legislative framework -

The current primary legislation under which the Building Societies operate is the Building Societies Act 1986. The main features of the legislation are:

- Societies are mutual institutions owned by investors and borrowers.
- The supervisory body is the Building Societies Commission. However, the Registry of Friendly Societies has certain functions regarding Registration of documents.
- Societies are only allowed to undertake businesses specified in the Act and the subsequent statutory instruments; for example, Building Societies must raise at least 60% of their funds from retail sources and their assets must predominantly be first mortgage loans to owner-occupiers of residential property.

- **Permitted Activities -**

Schedule 8 of the Building Societies Act 1986 and the Building Societies Order 1988, list the services which Building Societies are empowered to provide. These are:-

- Banking Services
- Investment Services
- Insurance Services
- Trusteeship
- Executorship
- Land Services

- **Regulation -**

Under the Act, the Building Societies Commission is charged with administering the system of regulation of Building Societies. The Commission is responsible for:-

- Guidance to Building Societies generally on specific aspects of prudent management.

- Other means of influencing the climate of opinion in societies, including specific seminars, speeches and articles by Commissioners.

- Annual meetings with the majority of societies, reviewing their prudential position in relation to their policies and plans.

- Monitoring the performance of societies during the year. Building societies submit returns to the Commission similar to those submitted by the banks to the Banking Supervision Division of the Bank of England. Building Societies are required to meet the Commissions' Capital Adequacy Guidelines, although these will be superseded by the EEC requirements which apply to all credit institutions within the member states.

- Inspections, either by Commission staff or by accountancy firms acting on behalf of the Commission.

- Consultation on specific aspects of a society's business.

C. INVESTMENT SERVICES

- Background -

The Financial Services Act 1986 (FSA) provides a unified and comprehensive system for the regulation of investment business conducted in the UK including the investment business carried on by the Banks. The basic principle of the Act is that it will be a criminal offence to carry on investment business without authorization or exemption. The granting of authorization and administration of the system of regulation and supervision rests with the Securities and Investments Board (SIB). The SIB in turn delegates much of the detailed work to five Self-Regulating Organizations (SROs).

There are a number of ways of obtaining authorization. Most firms involved in investment business have applied to be authorized by either the SIB directly or one of the SROs. Each SRO covers a particular type of investment business, although there is some overlap. Nevertheless, some firms may need to join two or more regulatory bodies for different aspects of their investment business. Membership is also on a firm by firm, not on a group, basis. Thus each company in the Barclays Group, involved in investment business, has had to join one or more regulatory bodies as indicated in the Appendix 2 containing the outline Barclays Bank Group structure.

- Jurisdiction of Self Regulatory Organizations

The SROs, and the types of business which they regulate areas follows:-

The Securities Association (TSA)	Firms dealing and broking in securities, investment management, forward agreements and related futures and options, international money market instruments.
The Association of Futures Brokers and Dealers (AFBD)	Firms dealing and broking in futures and options; investment management and advice incidental to this business.
The Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA)	Firms dealing and broking in life insurance, securities and collective investment products; investment managers and advisors.
The Investment Management Regulatory Organization (IMRO)	Investment managers and advisors, including managers and trustees of collective investment schemes; in-house pension fund managers.
The Life Assurance and Unit Trust Regulatory Organization (LAUTRO)	Life companies and unit trust managers and trustees, for the management and selling of insurance-linked investments or units in a collective investment scheme by themselves and their tied sales force.

Certain professions, such as Accountants and Solicitors, for whom investment business forms an element of their activities, may carry on such business according to the rules of their Professional Body. These Professional Bodies are recognized by the SIB as having rules equivalent to an SRO.

The SIB also has powers to recognize Investment Exchanges, Clearing Houses and the like.

- Regulation of Overseas Firms -

Overseas firms wishing to carry on investment business in the United Kingdom may do so under certain circumstances:

1. Firms from other EEC Countries, provided they are authorized by their home country.
2. Firms from certain countries/territories where the SIB has recognized that those places have an equivalent level of investor protection to the United Kingdom.

3. An overseas firm can apply direct to the SIB for authorization.

Regulation comprises both the financial aspects of the firm and its conduct of business.

- Financial Regulation -

The Financial Regulations involve the maintenance of adequate levels of capital and regular financial reporting in a laid down format.

The capital required by an investment business and the format and frequency of the reports varies with the regulator and the type of business involved.

Thus, an unincorporated firm selling insurance and not holding clients money will have only a basic solvency test and a relatively simple reporting requirement. A large securities firm will, on the other hand, have a substantial capital requirement based, at least in part, on its level of trading and position risk requirements as well as submitting reports on a weekly basis.

Such a firm may also need to satisfy the regulators as to the sophistication of its accounting system. Most firms will also need to submit an annual report from their auditors in a format specified by the regulator.

As well as the financial reporting requirements, our regulators, IMRO, require a Half Yearly Statement of Representation, signed by the Senior Executives of the Bank, confirming that we are in compliance with the regulations.

In addition, there are requirements for the up-dating of information previously provided to the regulators and for reporting information considered to be of regulatory importance. This latter category would involve such items as changes in directors, controllers, complaints received or disciplinary action by another regulator.

- Recent and Proposed Changes -

Since the introduction of the new legislation two years ago, it has been recognized that the present structure is both cumbersome and costly. Changes to the law were recently effected to enable a new approach to be adopted to the conduct of business rules.

The essence of the new policy is to simplify the present complexity and diversity in the regulatory rule books. This is to be achieved by a simple, common core of obligations, restating the essential gist of the present rules. Individual SROs will be able to adapt this core, to apply to their specific membership.

The new approach involves three tiers of regulation as follows:

a) The set of PRINCIPLES, setting out the main elements of the conduct and financial standing expected of all regulated investment businesses, which are of relevance for disciplinary purposes, although they cannot be used by investors as grounds for action under the FSA.

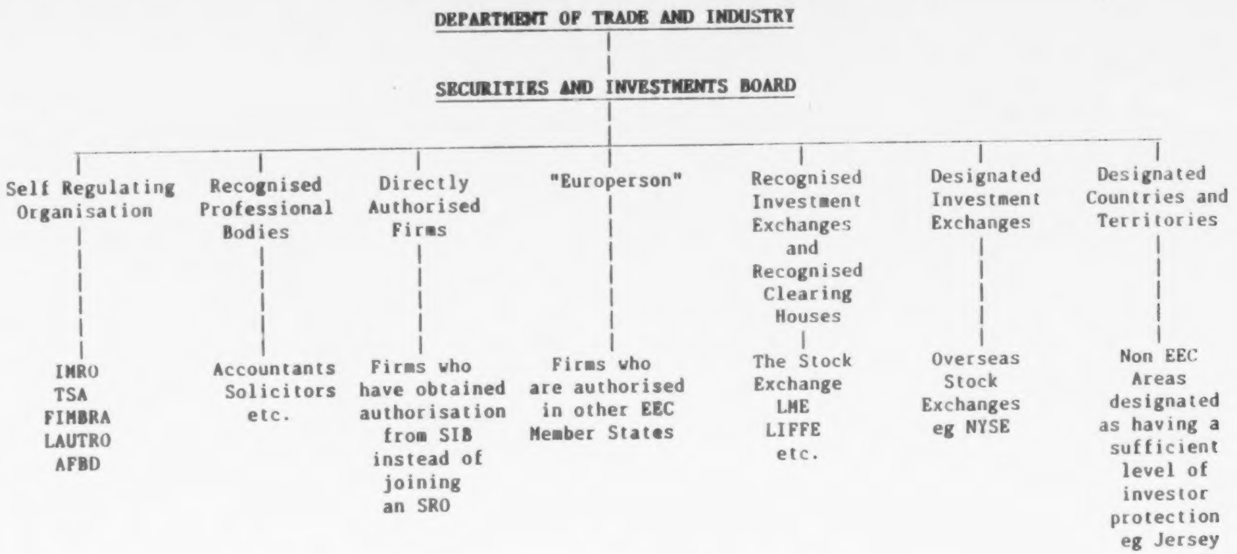
b) Secondly, a set of core rules which are currently being drafted by the SIB, in consultation with the SROs which will be common to all SROs and which will serve as an enforceable backbone for the regulatory system.

c) Detailed support which may take the form of rules, codes of practice or any other means chosen by the relevant regulator and which, therefore, may differ as between SROs.

The regulators have also, rightly, made it absolutely clear that, in their view, Compliance is the responsibility of a firm's Chief Executive Officer.

All banks will of course be required to produce the prudential returns for the Banking Supervision Division of the Bank of England.

FINANCIAL SERVICES ACT - REGULATORY STRUCTURE


DEPARTMENT OF TRADE AND INDUSTRY
SECURITIES AND INVESTMENTS BOARD
Self Regulating Organisation
IMRO
TSA
FIMBRA
LAUTRO
AFBD
Recognised Professional Bodies
Accountants
Solicitors
etc.
Directly Authorised Firms
Firms who have obtained authorisation from SIB instead of joining an SRO
"Europerson"
Firms who are authorised in other EEC Member States
Recognised Investment Exchanges and Recognised Clearing Houses
The Stock Exchange
LME
LIFFE
etc.
Designated Investment Exchanges
Overseas Stock Exchanges eg NYSE
Designated Countries and Territories
Non EEC Areas designated as having a sufficient level of investor protection eg Jersey

D. WHOLESALE MARKETS BUSINESS

Under Section 43 of the Financial Services Act, responsibility for the regulation of the wholesale markets in sterling, foreign exchange and bullion rests with the Wholesale Markets Supervision Division of the Bank of England. This Division is quite distinct from the Banking Supervision Division.

In 1988, the Bank of England published "the Grey Paper", setting out how it intends to supervise the wholesale markets. In broad terms, the Bank regulates wholesale market business transacted between professional investors or those who deal in amounts suggestive of their being able to pay for professional advice.

Regulation is achieved by:

1. Maintaining a list of authorized institutions to ensure that the quality of all those who act as market makers or as brokers can be monitored.

2. The revised "London Code of Conduct", the principal elements of which include the obligation to maintain the highest reputation for the London markets; the responsibility of management to maintain full control over dealers; adherence to market procedural rules; and the maintenance of confidentiality.

With respect to financial resources, all listed institutions need to meet capital adequacy tests designed to ensure that risks taken are not disproportionate to the firm's resources.

E. LEAD REGULATION

To reduce the burden of procedural and reporting requirements under the SIB and the Bank of England frameworks, a concept of lead regulator has been established which assigns the responsibility for the adequacy of the financial resources of firms to the regulator most directly responsible. For most banks, the SIB, the SROs and the Wholesale Markets Supervision Division have delegated regulatory authority for receiving and analyzing financial information, including capital adequacy, to the Banking Supervision Division.

APPENDIX 2

OUTLINE STRUCTURE OF BARCLAYS BANK GROUP

The listed holding company for the Group is Barclays PLC whose main asset is the entire issued share capital of Barclays Bank PLC.

Barclays Bank PLC is the principal operating company of the Group and also holds the group interests in the other operating groups. These are:

Barclays de Zoete Wedd Holdings Limited
Barclays Financial Services Limited
Mercantile Group Plc
Barclays Commercial Services (Holdings) Limited

These in turn hold the shares of the companies making up their groups.

In addition, Barclays Bank PLC holds the shares of a number of overseas subsidiaries operating in various countries worldwide. These include, for example:

Barclays Bank SA (France)
Barclays Bank SAE (Spain)
Barclays Financial Services Italia SpA (Italy)
Barclays Bank (Suisse) SA (Switzerland)
Barclays Bank of New York NA (United States)
BarclaysAmericanCorporation (United States)
Barclays Bank of Botswana Limited (Botswana)
Barclays Bank of Kenya Limited (Kenya)
Barclays Bank of Zimbabwe Limited (Zimbabwe)
Barclays Bank of Canada (Canada)
Barclays Bank Australia Limited (Australia)

This appendix gives an outline of the major companies in the group and summary comments regarding their activities. The list is far from comprehensive and is intended to show the variety of business undertaken by the Barclays Group.

As an addendum we have included the 1989 Annual Report on Form 20-F which gives more information.

BARCLAYS BANK PLC

Provides a full banking service for personal and corporate customers, including lending, deposit, money transmission, treasury, foreign exchange, and credit card services.

In the UK the branches are not only the principal source of revenues and profits, but also act as a distribution network for financial products and services developed by the Group's other divisions, such as insurance, share dealing services, Barclaycard, travellers cheques and travel services.

Barclays Bank provides a fully integrated global securities service including new issues, share registration, corporate trustee and custodial services.

The Group is regulated by the Bank of England and the Bank is a member of IMRO for its regulated investment management business.

BARCLAYS DE ZOETE WEDD HOLDINGS LIMITED

The Barclays de Zoete Wedd group consists of a holding company, Barclays de Zoete Wedd Holdings Limited, with a number of subsidiaries, all of which (other than those engaged in investment management) are run as an integrated organization. The principal BZW operating companies and their activities are shown below.

Equities:

Barclays de Zoete Wedd Securities Limited (TSA,ISE,LTOE)
Barclays de Zoete Wedd Equities Limited
Barclays de Zoete Wedd UK Equities Limited
Barclays de Zoete Wedd International Equities Limited
Barclays de Zoete Wedd Research Limited

Market-making and distribution in domestic and international equities, convertible and hybrid issues, margin instruments, futures and options. Research in domestic and international equities.

Fixed Income

Barclays de Zoete Wedd Securities Limited
Barclays de Zoete Wedd Gilts Limited (TSA,ISE,BoE)
Barclays de Zoete Wedd Capital Markets Limited

Market-making and distribution in UK Government securities and other domestic sterling bonds, U.S. Government and Federal Agency securities, international debt instruments and swaps, margin instruments, futures and options.
Origination and distribution of corporate bond issues and commercial paper programs.
Research in economics, currencies and bonds.

Merchant Banking

Barclays de Zoete Wedd Limited (TSA,BoE)
de Zoete and Bevan Limited (TSA,ISE)
Barclays de Zoete Wedd Futures Limited (EME)
Barclays Development Capital Limited (TSA,ISE)

Corporate finance services as merchant banker for mergers and acquisitions, disposals, privatizations, share incentive schemes, capital raising, equity issues, placings, flotations, development capital, management and employee buy-outs, specialized loan packages, syndications, off-balance sheet financing. Treasury and securities related foreign exchange services.

Asset Management

Barclays de Zoete Wedd Investment Management Limited (IMRO,SEC)
Barclays de Zoete Wedd Property Investment Management Limited

Investment management services: fund management for pension funds and other institutional investors, property management for institutional investors.

Overseas

There are various overseas subsidiaries in countries such as Australia, France, Hong Kong, Japan, the Netherlands, New Zealand, Singapore, Spain and the United States. These are responsible to the appropriate local regulation.

Key to Regulators:

BoE	The Bank of England
EME	European Mercantile Exchange
ISE	The International Stock Exchange
IMRO	Investment Management Regulatory Organization
LTOE	The London Traded Options Exchange
SEC	The Securities and Exchange Commission
TSA	The Securities Association

BARCLAYS FINANCIAL SERVICES LIMITED (BFS)

A holding company which, through its subsidiaries, provides a comprehensive range of corporate and personal financial services including Investment Management, Financial Planning, Executorship and Trust Administration, Personal Taxation, Management of Unit Trusts, Insurance Broking, Life Assurance, Pensions Fund Advice and Pensions Underwriting both in the United Kingdom and overseas.

The main activities of subsidiary companies and their regulatory bodies are:-

Barclays Bank Trust Company Limited

Financial planning, pension fund advice, executorship, trust administration, personal taxation, investment management.

Member of IMRO (for regulated investment business).

Barclays Life Assurance Company Limited

Marketing and underwriting of life assurance, savings and pension policies linked to managed unitized funds investing in directly held securities, including units of Barclays Unicorn unit trusts, and properties.

Regulated in the conduct of investment business by SIB.

Barclays Unicorn Limited

Manager of unit trust schemes and personal equity plan manager.

Member of IMRO and authorized by SIB.

Barclays Insurance Services Company Limited

A registered broker able to provide independent advice on a fully comprehensive range of all insurance products and services including employee pension schemes, together with financial planning.

Regulated in the conduct of investment business by SIB.

Barclayshare Limited

Provides stockbroking services linked to a customer's bank account, incorporating non-certificated share dealing and portfolio administration with advice if required. Manager of personal equity plans.

Member of the International Stock Exchange (ISE) and TSA.

Barclays Broker Services Limited

Dealing and administration for executive only stockbroking transactions on behalf of Barclays Bank branch network and Trust Company; provides stock exchange administration services to members of the International Stock Exchange. Administers the Barclays certified share dealing service.

Member of ISE and member of TSA.

Barclays de Zoete Wedd Portfolio Management Limited

International portfolio management service.

Member of TSA.

Barclays Insurance Brokers International Limited

Lloyds of London insurance broker.

Lloyds of London have by-laws not dissimilar from the rules relating to investment business regulated by the FSA. These are just coming into place and BIBI has submitted a detailed application to be placed on the Lloyd's register.

MERCANTILE GROUP PLC

Provides instalment credit, leasing and other financial facilities. Managers of the Barclays Unicorn group of unit trusts.

The group includes:

Mercantile Credit Company Limited

Instalment credit leasing and other financial facilities.

Barclays Mercantile Business Finance Limited

Provides leasing and financial facilities in respect of equipment and vehicles.

Barclays Mercantile Highland Finance Limited

Provides leasing and financial facilities in respect of agricultural and horticultural machinery and vehicles.

Dial Contracts Limited

Provides a complete vehicle fleet management service.

BARCLAYS COMMERCIAL SERVICES (HOLDINGS) LIMITED

Holding company for a group of companies providing factoring, invoice discounting and trade finance services.

BARCLAYS REGISTRARS LIMITED

Provides share registration and new issues services.

APPENDIX 3

COMPARISON OF REGULATORY REPORTING REQUIREMENTS

UNITED KINGDOM

Supervisory Authority	1. The Bank of England 2. The Securities and Investment Board and the self-Regulatory Organizations. 3. Various other statutory and non-statutory bodies.
Legislation	Banking Act 1987; Financial Services Act 1986; EEC directives.
Entry	Criteria covering minimum capital, procedure liquidity procedure quality of management, adequate accounting and other records and adequate systems of control.
Permitted	Mostly financial related, although other activities for banks not restricted by legislation.
Capital	Basle, EEC and TSA Guidelines on capital adequacy. Unlike other countries, Basle Capital Guidelines implemented in full at the end of 1989. Minimum levels negotiated individually with institutions.
Liquidity	No specific requirements but close reviews undertaken periodically.
Large loans	Quarterly returns to the Bank of England showing 20 largest exposures and all advances greater than 10% of capital base. Prior approval needed for advances in excess of 25% of capital base.
Inspection/ Audit	Comprehensive on site examinations, reporting accountants' reports on accounting and other records and internal control systems at least once every year

UNITED STATES

Supervisory Authority	Supervision of banks is divided between: 1. Federal Reserve System 2. Office of the Comptroller of the Currency 3. Federal Deposit Insurance Corporation 4. Various federal and state agencies Majority of banks come under both federal and state supervision.
Legislation	Federal Law and individual state law.
Entry procedure	Minimum requirements for capital; approval of management and business plan. Will vary according to whether the bank is applying for a national or state charter.
Permitted activities for banks	Generally confined to traditional banking activities. With limited exceptions, banks cannot undertake securities business (Glass-Steagall Act) or engage in insurance or commercial activity (National Bank Act and state banking statutes). There have recently been initiatives to expand permitted activity in the insurance area.
Capital adequacy	Federal supervisors' regulations require separate ratios to be calculated for primary and total capital (on a gearing type basis). Basle Convergence Capital Guidelines introduced in 1988.
Liquidity	No specific requirements, although close reviews are undertaken at the time of examinations.
Large Loans	15% of capital for federally chartered banks. State limits vary between 10 and 25% of capital, depending on State and security held.

Inspection/ Audit	Comprehensive on-site examination: for chartered banks this takes place at least once every three years. Also, limited interim examinations. Supervisory authorities tend to rely on their own examinations rather than on external auditors.

FRANCE

Supervisory Authority	1. Banking Commission: responsible for monitoring compliance with regulations. No staff of its own - relies on central bank to carry out much of the supervision. 2. Committee on Bank Regulation (COBR) - technical body to establish regulations, ratios, accounting standards etc. 3. Committee on Credit Institutions (CCI) - new licenses, technical decisions.
Legislation	Banking Law 1984 set up single supervisory structure, EEC directives.
Entry procedure	Criteria set down in Banking Law, covering capital, proposed activity and quality of management. Authorizations granted by CCI.
Permitted activities for banks	Banking and financially related activities, including securities, underwriting etc.
Capital COBR	Minimum ratios set by adequacy based on convergence capital guidelines.
Liquidity	COBR empowered to set minimum levels. Short-term ratio requires liquid assets of 100% of 1 Month Liabilities. Capital assets should cover 60 percent of medium and long-term loans.
Large loans	No more than 50 percent of capital allowed in lending to one customer (does not apply to bank - if less than 1 year - or government guaranteed credits). In addition, total of loans exceeding 25 percent of capital must not be more than eight times own funds.

Inspection/ Audit	On-site inspections by central bank (for a normal bank, every 4/5 years). Commission can refuse appointment of auditors.

GERMANY

Supervisory Authority	Federal Banking Supervisory Office (FBSO), reporting to Ministry of Finance: exercises its functions in close collaboration with central bank. FBSO responsible for detailed regulations; central bank consulted on appropriate ratios, etc, and collects supervisory data.
Legislation	Banking Law (last amended 1985) defines scope of supervisory system, EEC directives.
Entry procedure	FBSO sole authority for authorization; criteria covering minimum capital, proposed activity and quality of management.
Permitted activities for banks	Banking and financially related activities. German banks have substantial capital investments in corporate customers, e.g. Deutsche Bank in Daimler Benz AG.
Capital adequacy	FBSO, in conjunction with central bank, has established certain "Principles". Principal 1 states that a bank's loans and participation may not exceed eighteen times capital, calculated on a risk asset basis. This and principal 1A are being extended to include "off balance sheet" items such as swaps, caps and collars.
	Banks are also required to evaluate the impact of interest rate changes on their balance sheet on a regular basis.
Liquidity	FBSO's Principles also cover liquidity; complex formulae covering short, medium and long term liquidity.
Large Loans	Loans to any group of related customers not to exceed 50 percent of capital. Also limit on aggregate of large loans. Special reporting for loans to parties connected with lender which are deducted from own funds.

Inspection/ audit	FBSO entitled to inspect, with or without particular cause. The inspectors used will be auditors, Bundesbank officials or FBSO staff. Auditors appointed by the bank must submit their report to FBSO.

APPENDIX 4

DEPOSIT INSURANCE SCHEMES IN THE UK

A. BANKS

Section 29 of the Banking Act 1979 and Part II of the Banking Act 1987 provide for the establishment of the Deposit Protection Board and the Deposit Protection Fund.

The Board is responsible for levying contribution for the Fund from authorized institutions and placing this money in an account with the Bank of England. As far as possible, the Bank invests the money in Treasury bills and all income from investments is credited to the fund. All authorized institutions are expected to contribute to the Fund, with the initial maximum contribution being not more than 0.3% of an institution's deposit base. The minimum size of the fund is £5 million and the maximum £6 million, although if at any time payments are likely to exhaust the fund, the Board may, with the approval of the Treasury levy special contributions to meet the Fund's commitments.

Deposits are protected for up to 75% of a depositor's funds with a maximum of £20,000, although this limit can be changed by statutory instrument. The deposit insurance scheme covers all sterling deposits with institutions authorized in the UK by all UK as well as non-UK residents.

B. BUILDING SOCIETIES

Sections 24-30 of the Building Societies Act 1986 provide for an Investment Protection Scheme. This scheme is similar to that provided by the Banking Act with the exception that investors are protected for up to 90% of deposits. The maximum protected investment is £20,000 but as with the Banking Act there is a provision for this figure to be varied by statutory instrument.

Contributions to the Investor Protection Fund are limited to 0.3% of a building societies' share and deposit base, although there is a provision for this figure to be changed by statutory instruments.

C. INVESTMENT SERVICES

Power to establish a compensation scheme was conferred on the Secretary of State by Section 54 of the Financial Services Act was vested in the SIB by the Delegation Order 1987. Most authorized firms will be required to participate in the scheme, notable exceptions being building societies and life offices. Under the scheme, investors may be eligible for compensation of up to £48,000 made up of 100% of the first £30,000 of eligible loss and 90% of the next £20,000. There is also a limit of £100 million on all claims in each financial year.

Funding is by a levy on authorized firms. The fund is operated by a Management Company. Up to a point each category of business is self contained; compensation costs arising due to the failure of a firm are recovered from other members of the SRO of which the defaulting firm was a member. However, there are provisions for cross-subsidization from other categories once certain prescribed limits for contributions are reached.

The scheme does not cover:

(i) Investment business done before the scheme started on 27th August 1988.

(ii) Professional investors investing on their own account.

(iii) Business investors, or experienced investors, investing money maintained with the investor's consent other than in a clients' money account.

(iv) Unauthorized business or business with UK interim authorized firms.

(v) Investments overseas.

D. WHOLESALE MARKETS

There is no compensation scheme in respect of wholesale markets. Section 43 gives exemption to listed firms from the compensation provisions in the FSA.

E. CREDIT UNIONS

There is no compensation scheme and credit unions must insure themselves against loss through fraud or other dishonesty for a minimum of £20,000 per claim.

APPENDIX 5

STATUS OF EC FINANCIAL SERVICES DIRECTIVES

A. INVESTMENT SERVICES DIRECTIVE

STATUS: Proposal

PURPOSE OF DIRECTIVE

The Directive permits an investment firm authorized in one member state to provide those investment services throughout the community on a branch or service basis without having to seek further authorization from the host member state.

It should be noted that the definition of investment firm includes credit institutions authorized to undertake securities activities. Consequently, certain aspects of the Directive are applicable to credit institutions, namely:

- access to organized exchanges located in other member states,
- provision of own funds against market risk, and
- continuing compliance with prudential rules.

SUMMARY OF CONTENTS

The Directive specifies the minimum prudential requirements that an investment firm must meet in order to obtain authorization. These requirements include certain capital requirements that are dealt with in detail within the Capital Adequacy Directive.

Persons holding interests in 10% or more of the capital or voting rights, capable of exerting significant influence must be suitable.

It sets out the conditions on which an investment firm authorized in one member state can provide investment services into or establish branch representation in another member state on the strength of its home country authorization.

The Directive also provides for access to be given to organized exchanges located in other member states. Provision is also made for relations with third countries which are consistent with those contained in the Second Banking Directive.

PROPOSED DATE FOR IMPLEMENTATION

1st January 1993

CAPITAL ADEQUACY DIRECTIVE FOR INVESTMENT FIRMS AND CREDIT INSTITUTIONS

STATUS: Proposal

PURPOSE OF DIRECTIVE

To set minimum standards of capital adequacy which EC investment firms have to meet.

SUMMARY OF CONTENTS

Investment firms including credit institutions will be required to have sufficient capital to cover the risks arising from foreign exchange.

Credit institutions may, subject to the option of the competent authority of the country concerned, be given the ability to apply the Capital Adequacy Directive, rather than the Solvency Directive, to determine the minimum amount of capital required to cover the position and counterparty risks arising from their trading activities.

Investment firms that are not credit institutions will be required to have sufficient capital to cover the position and counterparty risks arising from their securities activities.

In addition, investment firms that are not credit institutions will be required to meet an expenditure requirement by putting up sufficient capital to cover three months' fixed expenses.

The Directive sets out an alternative definition of capital that will be applicable to investment firms that are not credit institutions. The definition is based upon that contained in the Own Funds Directive which is then adjusted to take account of intangible and illiquid assets and unaudited profits. In the case of credit institutions, they may, subject to the relevant competent authorities decision, apply an alternative definition of capital to support their securities trading activities. This involves the use of short term subordinated loans that do not meet the requirements laid out in the Own Funds Directive. In the case of both investment firms that are not credit institutions and credit institutions, both upper limitr are placed upon the extent to which short term subordinated loans may qualify as capital for regulatory purposes.

PROPOSED DATE FOR IMPLEMENTATION

1st January 1993

SECOND COUNCIL DIRECTIVE ON THE CO-ORDINATION OF LAWS, REGULATIONS AND ADMINISTRATIVE PROVISIONS RELATING TO THE TAKE UP AND PURSUIT OF THE BUSINESS OF CREDIT INSTITUTIONS

STATUS: Adopted December 1989

PURPOSE OF DIRECTIVE

The Directive, which amends the first Banking Directive (77/780/EEC), permits a credit institution to undertake cross border business within the EC on a branch or service basis without having to seek further authorization in the host member state.

SUMMARY OF CONTENTS

A credit institution is defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.

In addition to this business, a credit institution may be authorized to carry out securities related activities listed in the annex.

The Directive sets out the minimum standards of authorization and prudential supervision to be adopted throughout the Community. This includes a minimum capital base of ECU 5 million (lower for certain types of credit institutions' holdings in non-financial companies).

It establishes the right for a credit institution authorized in one member state (home member state) to carry out business on either a branch or service basis in another member state (host member state) without having to seek further authorization.

It provides for co-ordination and consultation between supervisory authorities. It covers relations with third countries.

PROPOSED DATE FOR IMPLEMENTATION

1st January 1993

COUNCIL DIRECTIVE ON A SOLVENCY RATIO FOR CREDIT INSTITUTIONS

STATUS: Adopted December 1989

PURPOSE OF DIRECTIVE

To specify the minimum harmonized risk asset ratio to be met by all EC credit institutions.

SUMMARY OF CONTENTS

It sets out the minimum standards of capital adequacy which EC credit institutions have to meet by establishing a uniform method of assessing the ability of credit institutions to meet credit losses arising from the default of their customers.

The risk asset ratio relates the capital of a credit institution, as defined in the Own Funds Directive (the numerator of the ratio) to its total assets and off-balance sheet liabilities, adjusted to reflect differing degrees of risk (the denominator of the ratio).

PROPOSED DATE FOR IMPLEMENTATION

1st January 1993

COUNCIL DIRECTIVE ON THE OWN FUNDS OF CREDIT INSTITUTIONS (89/299/EEC OF 7TH APRIL 1989)

STATUS: Adopted April 1989

PURPOSE OF DIRECTIVE

To establish a common definition of capital base for credit institutions.

SUMMARY OF CONTENTS

The Directive aims to establish a common definition and classification for the capital base of credit institutions as a basis for setting minimum levels of capital adequacy.

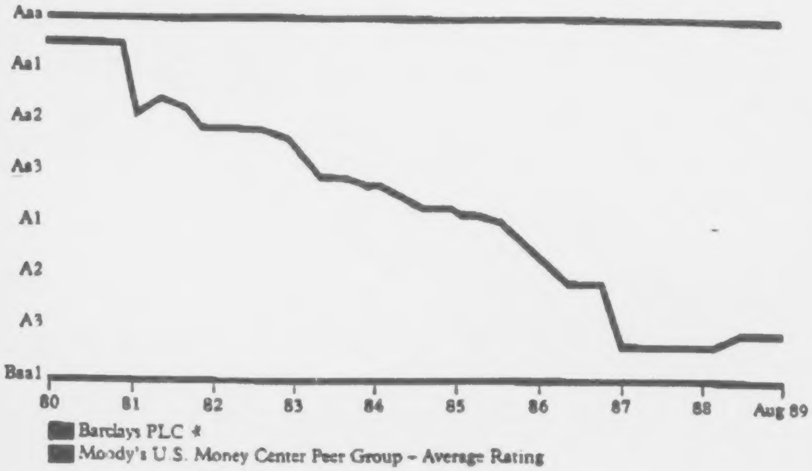
Also the definition is used as a basis for computing the capital base applicable to investment firms which are not credit institutions (refer to the Capital Adequacy Directive).

PROPOSED DATE FOR IMPLEMENTATION

1st January 1993

BARCLAYS GROUP

CREDIT RATINGS: 1980-1989



Source: Moody's Rating Agency - Investors Service

BARCLAYS

ECONOMICS DEPARTMENT REPORT

OVERCAPACITY IN BANKING

MAY 1990

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OVERCAPACITY IN BANKING

1. OVERVIEW

Overcapacity is the condition in which operating levels are too low to provide an adequate long-term return on capital. It can be caused by an unexpected fall in demand or by an excessive growth in supply. The excessive growth in supply might be due to technological change or an influx of new competitors, perhaps following deregulation.

Normally, overcapacity is a temporary phenomenon and is competed away by other things being equal, the lowest-cost producers forcing out the highest-cost producers. There may, however, be circumstances where the normal market mechanism does not work smoothly and overcapacity persists. Such circumstances might include:

a) where exit costs for a company are high and exceed the estimated costs of subsidising the activity until it becomes profitable. Clearly, if all market participants take the same view the overcapacity could persist for a long time.

b) where, as in many multi-product industries, participants cannot allocate costs accurately and so find it difficult to pinpoint which products are losing money.

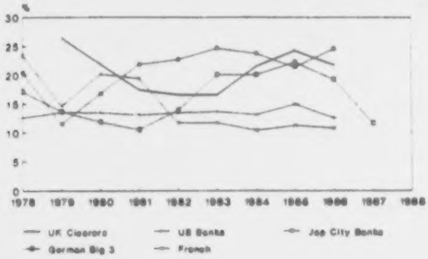
c) where there are cross-selling opportunities.

d) where participants have other interests which outweigh profitability e.g. liquidity considerations or the wish to be seen in a particular market perhaps for strategic or publicity reasons.

Just because the profit margins within an industry or for a major company in the industry are falling does not mean that there is overcapacity. It might simply mean that the market is becoming more competitive, or even be a temporary cyclical development. In banking, for example, the combination of low entry costs in some sectors together with growing freedom of entry is likely to mean that the industry does become highly competitive.

In fact, banking in the United Kingdom has to date been a relatively profitable activity compared to banking in other countries (Graph 1.1). This is, perhaps, surprising in view of the increase in competitive pressures in the United Kingdom brought about by deregulation over the last two decades and when set against the relatively protected nature of banking markets in many other countries. Banking is averagely profitable when compared with many other business sectors in the United Kingdom (Graph 1.2).

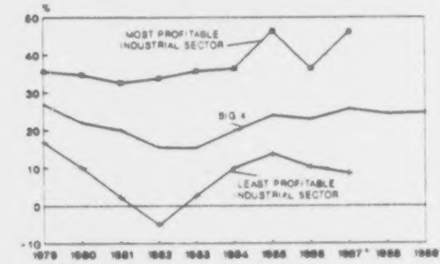
1.1 PROFITABILITY-INTERNATIONAL COMPARISONS
RETURN ON SHAREHOLDERS' FUNDS



Source: OECD

The current level of profitability in banking does not suggest that it suffers from overcapacity. However, banking has recently experienced an extraordinary boom, which may have disguised far less favourable trends. There are clearly individual business areas which do suffer from overcapacity at present (most obviously securities trading) and others which might be expected to suffer from overcapacity in the future. This study splits banking into sectors; personal or retail; corporate sector business according to size; and securities-related activities, and looks at the present competitive position in each, likely changes in the near future and the impact of these changes on profitability. It ends with a note on the role of technology, particularly in relation to electronic fund transfer.

1.2 PROFITABILITY-DOMESTIC COMPARISONS
RETURN ON SHAREHOLDERS' FUNDS



Source: CLSB, ICC and Annual Reports
* Excluding LDC provisions

2. THE MARKET FOR RETAIL BANKING SERVICES

The market for retail banking services includes:-

a) Collection and intermediation of household savings.
b) Issue of savings instruments.
c) Provision of consumer loans and mortgages.
d) Payments services and instruments.
e) Brokerage and advisory services.

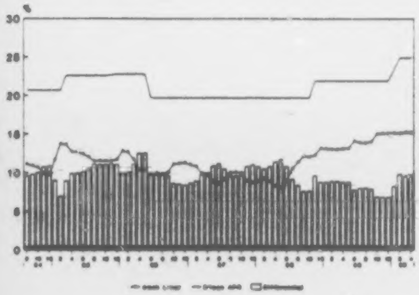
Present Position

These markets have been one of the most important growth areas and sources of profitability for banks over the last twenty years. The sector has benefited from both the growth of personal income and wealth and greater market penetration.

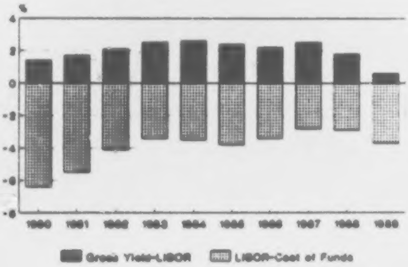
The profitability of the market for retail banking services derives both from money transmission (by virtue of the large balances held in accounts) and lending business. Despite increased competition there is no evidence of overcapacity as measured by profitability. Margins on most personal sector business remain among the highest of all areas and, even after high costs, returns are substantial. Barclayloans, for instance, remain very profitable (Graph 2.1) with margins of around 10%. Fluctuations around this level seem to be related to the interest rate cycle rather than any increase in competition. Similarly, although the returns on credit card business have declined in most recent years, possibly as competition has increased, returns remain well above the average for banking as a whole.

Most competition appears to have been on the deposit-gathering side rather than lending margins, as evidenced recently by the move to interest-paying current accounts. This can be seen in Graph 2.2 which shows that most of the reduction in the interest rate margin which has taken place since the start of the 1980s has been accounted for by a rise in the cost of funds in relation to LIBOR.

2.1 LIBOR vs BARCLAYLOAN APR



2.2 BORROWING & LENDING MARGINS
BARCLAYS DOMESTIC BUSINESS



Source:Annual Report

Outlook

Supply: The level of profitability of most retail banking services is attracting competitors into the market. Competition in some or all services is increasing from:-

i) Building societies.
ii) Retailers.
iii) Specialists - such as The Mortgage Corporation for home loans, stockbrokers for brokerage and advisory services.
v) Direct Marketing e.g, Masterloan, Midland.

Regulatory barriers to entry are few and falling. Essentially, entry is unrestricted provided that certain conditions, which apply to all participants, are met, and ability to compete effectively is dependent more upon the ability to deliver. Many of the banks' potential competitors have branch networks but physical delivery systems are becoming less important e.g. direct postal marketing.

Demand: Demand for financial services in total tends to grow faster than overall spending. However, the market for some services may be approaching saturation point. In 1986, 60% of adults in the United Kingdom had a current account and 64% had a building society account. Increases in volume of business by any one institution are likely to be possible only by taking business away from other institutions. Indeed, as banks and building-societies become more alike, multiple account holding may decline, reducing total demand for this type of service. At the same time, as income increases, demand for more sophisticated services grows, including demand for investment vehicles and brokerage and advisory services.

Since building societies and other financial institutions will also be gearing up to compete in these markets this raises the question of whether there is enough business to support the present extensive branch network. If over-capacity persists the most likely response will be a reduction in the branch network.

The accompanying notes look at two sectors of retail banking services in more detail.

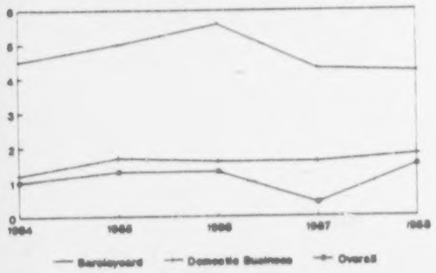
CASE STUDY 1: Credit Cards

Issuers of credit cards have made returns on capital employed well above average for their business as a whole over the last five years. The return on lending is also higher than returns on domestic lending (Graph 2.3). Unsurprisingly this has encouraged market entrants and competition is beginning to increase, and is beginning to have an impact on returns. Increasing competition is evidenced by:

a) Issue of cards by new competitors bearing lower rates of interest (Graph 2.4). These have yet to make a significant impact on the business of the main card issuers, where interest margins have in the past been affected mainly by movements in the interest rate cycle. As with Barclayloan, however, it is not yet clear whether the recent fall in margins is due entirely to the rise in interest rates or whether increasing competition is also playing a part.

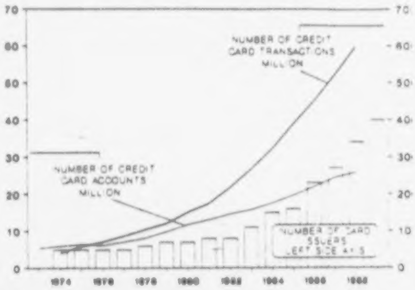
2.3 CREDIT CARD PROFITABILITY-UK

Return on Lending



Source: Monopolies & Mergers Commission

2.4 CREDIT CARDS



Source: DTI & the CLSB

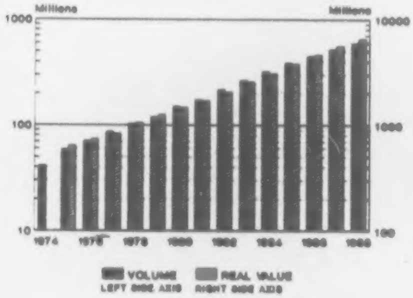
b) Decline in merchant service charges. However, much of this decline can be attributed to other factors besides competition, such as the growing acceptance of cards by low-margin high volume food retailers who tend to pay lower charges.

Outlook

1) Supply The rapid increase in numbers of issuers of credit cards recently seems likely to continue. Some banks have expressed their intention to enter the business but the main source is likely to be building societies which, following the 1986 Building Society Act, are now permitted to issue cards if they have assets in excess of £100 million. Of 65 societies eligible to do so, only seven were issuers as at March 1989.

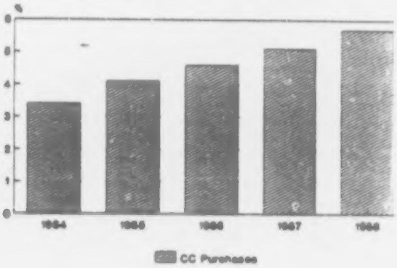
2) Demand Demand for credit cards as measured by the number of transactions (Graph 2.5) has grown fairly steadily over the last fifteen years, and so has the number of different types of card in issue. The number of credit card accounts has grown less rapidly through the 1980s (Graph 2.4) and on this measure the market for card holders may be approaching saturation. A new factor which could inhibit the growth in credit card numbers would be if the introduction of an annual charge encouraging rationalisation in card ownership. A far as credit card use is concerned, card transactions account for only a small but rising part of total expenditure (Graph 2.6) and the scope for supplanting cheques must be considerable (Graph 2.7). However, growth in demand may be inhibited by the growth of debit cards which could go a long way to replacing the means of payment function of the credit card, although this process may be slow as long as credit cards retain the advantage of the interest-free credit period.

2.5 CREDIT CARD TRANSACTIONS



Source:CLCB

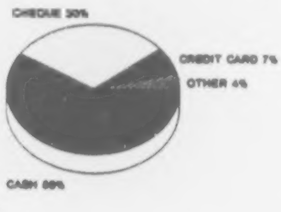
2.6 CREDIT CARD TRANSACTIONS
%TOTAL CONSUMERS' EXPENDITURE



Source: Monopolies & Mergers Commission

2.7 METHODS OF PAYMENT (1988)

UNITED KINGDOM*

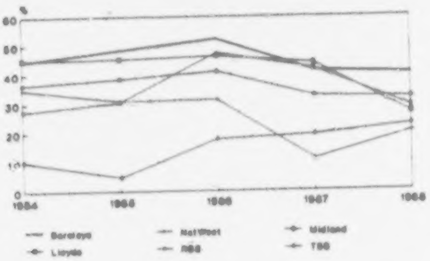


*Shop Purchases Over £10 in Value

Sou[illegible]dland Bank

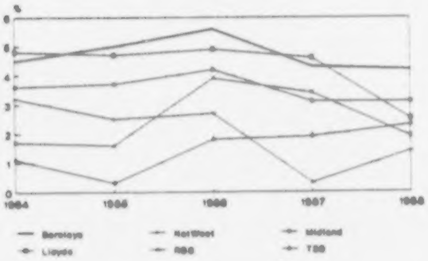
3) Conclusions While it is clear that the days of high profitability for credit cards are past, it is possible that the pessimism about future prospects is misplaced. At the moment profitability is well above average and any new entrants will take time to achieve the necessary volume an erode this profitability. However, studies show definite economies of scale in the credit card business and it is questionable whether, or how quickly many of the new entrants can attain the necessary volume for operations to become viable. Evidence from the United States, a more developed market, shows that, despite the multiplicity of cards, the profitability of credit card operations is at a record level. Besides, Barclays appears to be good at this particular business, with returns on lending and on capital usually above most other competitors (Graphs 2.8 and 2.9).

2.8 CREDIT CARDS
Return on Capital



Source: Monopolies & Mergers Commission

2.9 CREDIT CARDS
Return on Lending



Source: Monopolies & Mergers Commission

CASE STUDY 2: The Mortgage Market

The mortgage market has gone through a major transformation during the 1980s. On the supply side there has been a considerable increase in competition as banks and other specialist mortgage lenders moved into the market and the building societies have abandoned their cartel. At the same time, demand has soared owing to favourable economic and demographic factors.

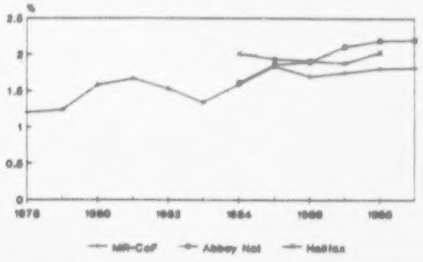
Despite the increase in competition from banks in particular, the evidence does not suggest that there has been any erosion of profitability in the mortgage market for the lowest cost suppliers, i.e. the building societies (Graph 2.10). Some have even managed to increase their interest margins while most banks have experienced a decline in their overall margins (Table 2.1).

Table 2.1: Domestic Net Interest Margin

	1984	1985	1986	1987	1988	1989
Abbey National	1.6	1.9	1.9	2.1	2.2	2.2
Halifax	2.0	1.9	1.9	1.9	2.0	n.a.
Barclays	5.8	6.2	5.7	5.3	4.7	4.3
Lloyds	6.3	6.1	6.0	5.8	5.4	5.2
Midland	5.7	5.7	5.1	5.2	4.9	4.1
NatWest	5.0	4.9	5.5	5.4	5.2	5.2

Source: Warburg and Annual Reports

2.10 BUILDING SOCIETIES
Interest Margin



Source: [illegible] and Warburg

However, the change in circumstances outlined above which would normally have had the effect of eroding the profitability of building societies, may have been concealed by a series of one-off adjustments such as:

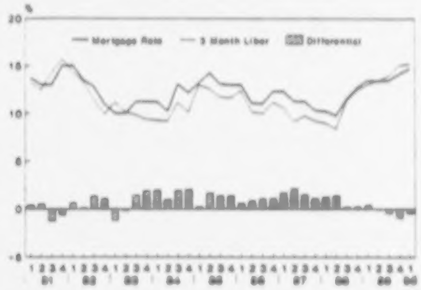
a) A decline in their liquidity ratio, representing a shift at the margin to higher yielding assets.

b) Strong growth in demand for mortgages at the same time as an increase in supply. Therefore, both supply and demand curves for mortgages have shifted.

c) Margins used to be artificially suppressed. The building societies did not charge as much as they could get for mortgages but restricted the supply, resulting in queuing.

The profitability of the mortgage market for banks has fluctuated widely with the course of wholesale market rates (Graph 2.11). As with other forms of lending, it remains an open questions whether the current prolonged squeeze on margins is due solely to the upward trend in interest rates or whether increased competitive pressures are also playing a role.

2.11 MORTGAGE RATE vs LIBOR



Outlook

Competition in the provision of mortgages has increased in recent years and is likely to increase further in future from suppliers such as The Mortgage Corporation offering a commoditised product. Their low-margin high volume approach may make it difficult for other lenders with high overheads such as banks to compete, forcing them to either drop out altogether or change strategy. The latter course may involve offering mortgages as part of a complete package to produce added value for which a higher price can be charged. Ease of entry into the sector, particularly if it does not require an expensive branch network, will ensure that unless companies adopt the value-added approach it will be difficult in the long term to earn anything other than normal profits.

3. THE MARKET FOR CORPORATE FINANCIAL SERVICES

Financial services provided to the corporate sector range from services to small businesses, which differ little from those provided to the personal sector, through more sophisticated services provided to middle corporates and complex services for large national and multinational companies. Generally, the smaller the company the more profitable is the banks' loan business while banks strive to earn fee income from large corporates. The following looks in turn at the large, medium and small corporate markets and finally at the syndicated credit market.

3.1 LARGE CORPORATE MARKET

Barclays principal services to large corporates fall under the following headings:-

i) Finance and Lending.
ii) Money Transfers.
iii) International Trade.
iv) Risk Management (Treasury products for interest and exchange rate risk and money market facilities).

Present Position

The large corporate market is characterised by strong competition. With regard to bank lending, this competition comes not just from other banks but also from securities markets and this has severely eroded the profitability of lendiing to large corporates. It can be seen from the graph that corporates can raise funds on dollar commerical paper markets at lower costs than LIBOR (which does not include bank's intermediation costs) owing to disintermediation and in many cases, superior credit ratings. As a banker in Euromoney (August 1989) says "You do not make money with prime names". The differential between commercial paper rate and LIBOR has narrowed since the early 1980s reflecting some recovery in the relative credit rating of banks. The extent of this improvement, however, is not significant.

As a rough guide, a bank with even the minimum capital to risk assets ratio of 8% would need to earn a margin of around 1.5% on a loan held on its books just to cover capital costs of, say, 18%, without reckoning on other costs which for the bank as a whole run at around 3% of total assets (although with large-scale lending costs would doubtless be less than this).

However, a recent example of aggressive pricing was a multiple option facility for British Aerospace which included a 5 basis point (bp) facility fee, a margin of 10 bp (rising to 12.5 bp if borrowing exceeded more than one half the agreed amount) and front-end fees of 3 bp - 5 bp. The original target was to raise $300 million but the deal was so popular that it ended up at $825 million. The rationale for the participating banks is the desire for a share in other B.Ae business but since there were 40 banks in this deal they could not all expect to pick up trade finance or forex business, particularly as the Big 4 clearers were not involved in the deal.

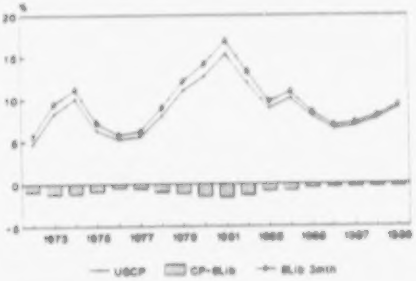
Outlook

Demand: There is unlikely to be any significant demand for funds by large corporates at a rate at which it is economic for banks to supply them. It is not possible for banks to compete against securities markets in the provision of funds. Instead, banks must concentrate on the provision of services at a competitive price. The reasoning behind 'relationship' banking, whereby banks provide below-cost funds in the hope of attracting other more profitable businesses, is ultimately flawed in that it implies the other business is overpriced in order to subsidise uneconomic lending and the danger is that banks are vulnerable to being undercut by specialist competition. The likelihood is that increasingly cost-conscious companies will put trade finance or forex businesses with the cheapest suppliers.

Supply: The large corporate market will remain highly competitive owing to the number and type of potential providers of services. Competition comes from:-

1) Securities markets, access to which is spreading down the corporate ladder with the creation of second tier and even third tier equity markets, although there are limits in terms of size. Because of access to e.g. the commercial paper market, banks cannot compete on the provision of finance owing to intermediation costs (Graph 3.1).

3.1 US COMMERCIAL PAPER vs LIBID



Source:Federal Reserve

2) Other banks pursuing the same strategy in servicing multinational corporations. This competition has resulted in compression of fees and margins on loans and other facilities.

3) Non-banks, such as accountants which are entering the market providing advice and even arranging finance.

4) Companies own banking units set up to manage group finances. Several multinational companies including BP, Volvo have set up in-house banks.

3.2 MIDDLE CORPORATE MARKET

Business with middle-sized companies is still profitable as these companies are not large enough to access securities markets. The profitability of this market derives largely from money transmission (by virtue of the large balances held in accounts) and 7-day deposits. Lending business is generally much less profitable, with overdrafts being only marginally profitable owing to a combination of high administrative costs and bad and doubtful debts.

Outlook

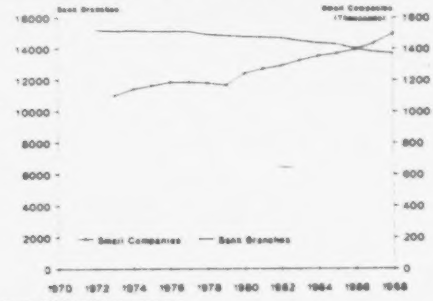
Demand: Middle corporates will continue to rely largely on the banking system for funds and financial services. Securitisation, as the US experience shows, can extend only so far down the corporate ladder.

Supply: Competition is concentrating increasingly on the profitable middle corporate market. Up to now, competition in this market has been limited to banks with branch networks with which to establish contact, although in future this may cease to be such an important factor for some services as systems such as EDI (electronic data information) are introduced which would enable companies to make payments themselves. Competition comes both from other UK banks and overseas banks.

3.3 SMALL CORPORATE MARKET

This is a comparatively profitable market segment, particularly the deposit and money transmission services, and lending business is also profitable as small companies have limited alternative sources of funds and competition is effectively limited to the main clearers with branch networks who constitute an effective oligopoly. There has also been considerable growth in the market in the past ten years as the number of small companies increased from around 1.2 million in the second half of the 1970s to around 1.5 million in 1988. (Graph 3.2)

3.2 THE SMALL CORPORATE MARKET



Source: CLSB and Companies House

Outlook

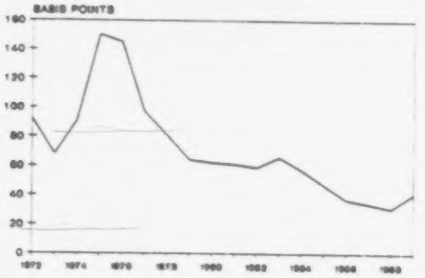
Demand: With little prospect of any alternative sources of external funds, small companies seeking to grow will continue to rely on bank finance. However, the boom years for small businesses may be at an end for the timebeing. They face more difficult trading conditions over the next few years as a result of higher interest rates and slower economic growth in conjunction with the substantial increase in their net debt seen in recent years. With new registrations at record levels in 1988 and 1989, numbers in the 'high risk' category i.e. young companies, are at record levels and Economics Department expects failures to exceed 200,000 in both 1990 and 1991, resulting in a slowdown in the rate of growth in numbers of small companies.

Supply: Although competition among providers of financial services has intensified considerably in recent years, this remains a profitable area, suggesting that there will be a further intensification of competition if other suppliers can enter the market. Meeting the many needs of small businesses still requires a branch network and the principal potential competitors are therefore the building societies. However, it is questionable how quickly building societies, under present or new ownership such as foreign bank, could establish the necessary contacts and expertise in dealing with corporate rather than personal customers. Thus, for the foreseeable future, the principal competitors are likely to remain the other clearing banks.

3.4 SYNDICATED BANK CREDITS

The syndicated credit market expanded rapidly in the 1970s, particularly as it catered for international financing needs after the first oil crisis. The evolution of the market is a good example of how competition erodes excess profits when there are no barriers to entry, or as the Bank of England study of September 1980 put it: "If the syndicated credit market is highly competitive the spreads determined in the market will equal the marginal cost of intermediation". The number of banks lending in the syndicated loan market increased from about 400 in 1976 to 700 in 1980. At the same time there was a marked decline in spreads (Graph 3.3).

3.3 SPREADS ON SYNDICATED LOANS
OECD BORROWERS



Sources: The World Bank and the OECD

Some banks, particuarly American and British, repeatedly complained that the market was becoming increasingly unprofitable. This was probably true for them given their circumstances. Table 1 shows the spread required to earn an economic return, broken down by components of costs. It can be seen that syndicated credits became unprofitable for British and American banks at spreads double those which were still profitable for French and Japanese banks. This accords with the perception that US Banks dropped out of the market to a large extent as lack of profitability (for them) persisted. British banks also became increasingly reluctant to participate, leaving the market to the lowest cost suppliers. Thus, while US and UK banks probably believed there were too many competitors and excess capacity, Japanese banks merely thought it was competitive. Needless to say, US and UK banks complained of dumping.

Table 3.1 Syndicated Credits - Breakdown of Costs % per annum

	US, British Canadian Banks	French/Japanese Banks	Italian Banks
Capital cost	1.08	0.32	0.09
Overheads	0.0055	0.0055	0.0055
Risk premium	0.33	0.33	0.33
Total	1.4155	0.6555	0.4255

Source: Euromoney

Nevertheless, US and UK banks did on occasions participate in deals which must be considered uneconomic on account of the low spreads. Several justifications were put forward for this.

a) Large banks can fund their credits at the bid side of the market which is slightly lower than the offered side which is the base for interest rates on eurocredits.

b) Lead banks earn additional fees over and above the participation fee, although spread over the life of a loan this would not raise the return significantly, particularly if additional costs are taken into account.

c) Intangibles, such as a long-standing relationship with the borrower or the desire to gain other profitable business (although in a competitive environment cross-subsidies are compared away).

The number of banks participating in the syndicated credit market has declined particularly since the debt crisis broke in 1982. Nevertheless, the margin on credits has not widened significantly, even during the apparent upsurge in demand over the last two years.

Spreads vs Fees

For banks participating in syndicated loans, revenue comprises both spreads and fees. While information on spreads is usually publicised, complete data on fees are rarely made available. In generally, the available evidence suggests that the level of fees moves in line with the level of spreads. While at any one time there may be substitution between fees and spreads if a borrower wishes to conceal the total borrowing costs (which reflects on their credit standing), over time the declining level of publicised spreads has not been offset by rising front-end fees.

4. MARKETS FOR SECURITIES - RELATED SERVICES

These encompass a broad range of services in both national and international markets.

Activities include:

1) New-issue business
2) Secondary market trading
3) Portfolio management
4) Investment advisory services

Present Position

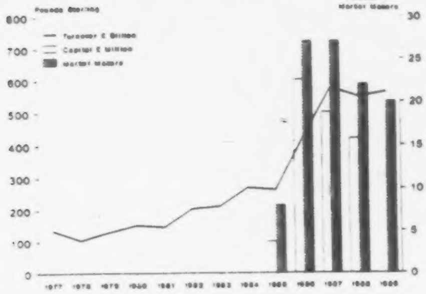
Available evidence, such as indicators of activity in new issue and secondary markets and the volume of funds managed by insurance companies and pension funds, suggests that the markets for all of these activities have expanded considerably over the past two decades. From the supply side, in the new issue (eurobond) business freedom of entry and the fact that this is seen by many banks and securities houses as a key strategic area has resulted in considerable competitive pressure. In securities trading, also regarded as a key strategic area, deregulation has enabled financial institutions to compete in sectors they were previously barred from and has also resulted in internationalisation, broadening the competition still further. Portfolio management and investment advisory services have expanded owing to their fee-earning potential, offering the opportunity to diversify away from on-balance sheet activity.

To a large extent the increase in competition in some segments of securities-related markets is a consequence of the pursuit of a global strategy by many financial institutions. This has resulted in a significant increase in the number of firms and capital involved, (Graphs 4.1, 4.2) giving rise to excess capacity, particularly in commoditised areas of secondary markets such as gilts and equity trading in London. Graph 4.3 gives some idea of the scale of losses currently being incurred on the London markets. It would appear to be difficult to make money in these trading activities. Evidence from New York Stock Exchange (see attached case study) shows that, while member firms have remained profitable, they have diversified their sources of revenue substantially since deregulation in 1975 to the extent that commission income has fallen from 55% of revenue in 1973 to 17% in 1988.

Outlook

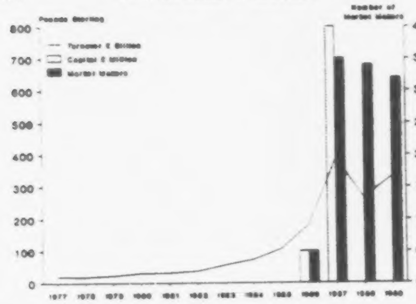
The overcapacity which exists in certain sectors, most obviously securities trading, which has arisen since London's Big Bang in October 1986 must inevitably result in withdrawals from the market, eventually raising profitability to more sustainable levels. However, because of the nature of the markets (high profile, key strategic area) they are unlikely ever to generate above average returns. There are always likely to be potential entrants, either domestic or from abroad, if the prospect of profits arise and freedom of entry will allow them to enter the market. This is confirmed by a Bank of England study of the eurobond market which found that, between 1975 and 1987 there had been 112 different firms in the table of top 50 issuing houses but only 16 had been consistently in the top 50, suggesting entry is easy but it is more difficult for a firm to establish itself as a dominant player.

4.1 THE GILTS MARKET



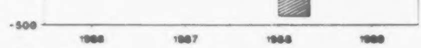
Source: ISE and ED estimates

4.2 THE UK EQUITY MARKET



Source: ISE and ED estimates

4.3 SECURITIES INDUSTRY PROFITABILITY



Source: Economist; FT

CASE STUDY: Stock Exchange Deregulation, New York and London Compared

In some respects the New York 'Big Bang' of May 1975 was comparable with that of London in 1986. The main similarity was the abolition of fixed commissions. However, in New York there was no change in the structure/ownership of the market. In London, by contrast, there was the introduction of dual capacity and elimination of barriers which prohibited banks from owning securities companies. This was associated with a massive rise in capital committed to the market, with capital committed to the gilt market rising approximately sixfold to £600m and to equities an estimated eightfold to £800m.

The effects of the abolition of fixed comissions in New York can be summarised as follows:-

1) Commission rates fell, eventually settling at about 60% of their old level. Revenue was less affected owing to an increase in turnover partly stimulated by lower dealing costs and partly by buoyant activity.

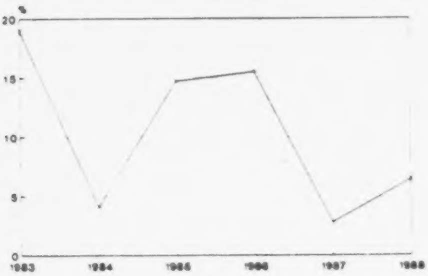
2) Falling margins prompted US brokers to develop new lines of activity so that commission income, which accounted for 55% of revenue in 1973 fell to 17% by 1988.

3) The fall in commission rates made many firms not viable and the number of firms in the industry declined substantially but the average size of surviving firms has since increased dramatically. Firms which lost out were those which devoted substantial proportions of their resources to research activities rather than to efficient execution services i.e. price became a dominant factor, customers being unwilling to pay a premium for information.

4) Although capital has grown from $3.7 billion in 1975 to $26.8 billion in 1988, this occurred gradually over time (unlike in London) with a significant proportion being generated internally from satisfactory profits.

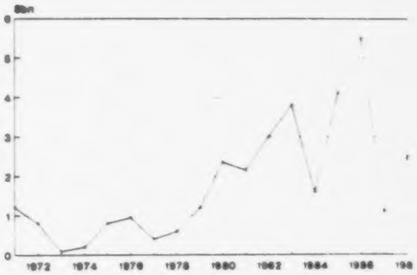
5) Other effects included an increase in block trades as a proportion of the total and an increase in the turnover rate. Employment steadily increased rather than rising rapidly, whereas in London employment doubled between 1984 and 1988.

4.4 NYSE MEMBERS' Return on Equity



Source NYSE

4.5 NYSE MEMBERS' Pre-Tax Profits



Source NYSE

5. THE IMPACT OF TECHNOLOGY

As banks increasingly use new technology to cut costs, increase efficiency and improve their services, the consequences for their internal structure and the banking industry cannot be overestimated. For example, without the automation that technology has made possible the volume of staff necessary to process bank's business would be significantly higher than current levels. This paper attempts to isolate those consequences that influence the nature and level of competition in the industry with particular reference to the concept of overcapacity.

Two sources of change in the nature of competition can be identified - from within the industry and from outside the industry as non-bank institutions start to operate in what are traditionally banking markets - but before these are considered it is useful to look in relatively broad terms at the impact of new technology on the cost structure of banks.

Technology and Banks' Cost Structures

Although at times the automation process may increase the initial 'set-up' costs of a bank's operations, it will usually lower the marginal costs of production as the staffing levels for a given volume of output are reduced. The net effect is usually an increase in the potential for a bank to reap economies of scale and a reduction in the unit cost of high volume business.

Competition from within the Banking Industry

One obvious implication of such a cost structure is that it provides a strong incentive for individual banks to raise volumes, increasing the likelihood of oversupply within the industry, in the short term at least. This high volume bias is exacerbated by the fact that many of the systems and items of equipment involved are large and the divisibility of operations may be severely curtailed.

There are, however, other possible outcomes:-

- Small banks unable to generate sufficient business to justify expenditure on new technology in certain areas of their busineess may cease operating in these sectors or close altogether.
- Merger and acquisition activity within the industry could increase.
- Greater co-operation and specialisation could occur with banks increasingly processing for each other.

A second influence of the heavy fixed cost element associated with the adoption of new technology relates to the high exit costs they imply. For example, the investment in technolgy necessary to establish a modern trading floor represents a sizeable expenditure and banks would be reluctant to close such operations even if over-supply in the market persistently pushed margins down to what would normally be unacceptably low levels. Two explanations exist. First, management may find it difficult to admit to shareholders that the costs they have sunk in this sector of their business were a mistake. Second, banks have to consider the costs of re-entry into the market if the environment should change to such an extent that a presence in this sector becomes more desirable. As a general rule markets where exit costs are high are particularly vulnerable to over-capacity, and in the calculation of exit costs some account of the cost of re-entry is not unreasonable. Clearly, if all market participants are reluctant to leave, then overcapacity could persist for a long time.

Competition from Non-banks

Although the greater use of technology will frequently favour the larger institutions and encourage banks to grow, this may not be so in every case. The OECD isolates EFT facilities as an example, arguing that as time progresses the associated technology is becoming more accessible and that savings institutions that have previously not participated in the payment system could benefit. This trend is already evident in the UK where building societies have used ATMs to raise the liquidity of their accounts, improving their competitive position vis-a-vis banks.

Greater competition is also becoming evident as new technology has encouraged some non-bank institutions to establish their own processing systems. To date, European banks still dominate the processing business in their regions but in America, General Motors and American Express, for example, have set up processing subsidiaries that compete with banks.

Technology and Banks' Delivery Systems

The industry's view is that whilst new technology will alter substantially the nature of costs, the traditional structure of the bank, with certain functions being fulfilled at the head office and others at the branch level, will remain relatively unchanged. It is, however, possible that the adoption of new technology will alter this structure. A combination of home banking, smart cards and high-tech ATMs could handle a majority of the mundane banking transactions, leaving a much reduced branch network just to market more complex financial instruments. Taking the argument a step further, institutions concentrating exclusively on core banking functions may be able to operate without an expensive branch network.

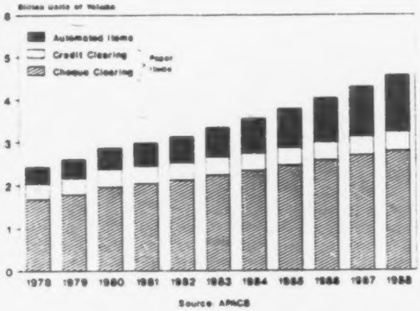
The need for an extensive branch network to penetrate a new market successfully has in the past acted as an effective barrier to the entry of competitors into the industry or a geographical region. Without this barrier, competition could increase, depending largely on the relative costs of a branch network compared with the new technology. (Information on comparative costs is scarce but in the case of home banking it seems that the telecommunications authorities, the information providers of public videotex machines, and maybe telecommunications companies could absorb a large proportion of the initial investment costs). However, for overcapacity to persist there must also be some rigidity in the market preventing the relatively inefficient producers from leaving.

CASE STUDY: Electronic Money Transmission

Recent Trends

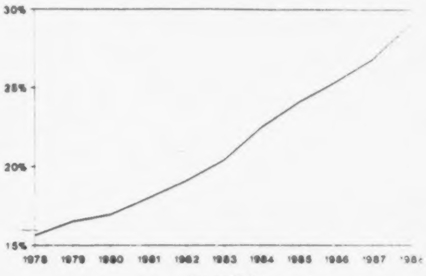
Increased demand can be viewed as a contributory factor behind the adoption of electronic methods in the various stages of the payment system. As the volume of paper processed by banks has risen (graph 1) so the incentive to seek ways of reducing unit costs has increased; an inclination exacerbated by a general extension of bank clientele to lower income groups and the corresponding growth in the proportion of business accounted for by relatively small transactions. Furthermore, the increase in demand has at times made the adoption of Electronic Fund Transfer (EFT) viable, by enabling banks to generate the critical volume of business necessary to make investment in these new systems economic. The result is an increase in the ratio of electronic to paper clearing transactions (Graphs 5.1 and 5.2).

5.1 UK CLEARING STATISTICS



Source: APACS

5.2 UK: AUTOMATED CLEARING AS A PERCENT OF TOTAL CLEARING

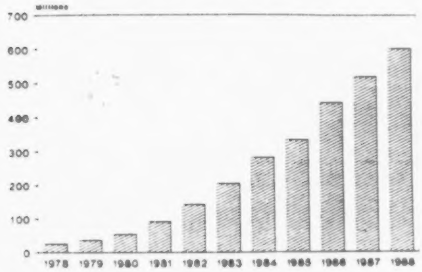


Source: APACS

In terms of demand for EFT as opposed to more traditional forms of money transfer, the consumers of the service are in certain cases relatively passive. For example, neither the retailer nor the customer currently perceive there to be any significant advantage to be derived from diverting payments from cash and cheques to an electronic point of sale (POS) system, especially if this would incur some charge. It therefore seems reasonable to conclude that the adoption of electronic systems, although encouraged by an overall increase in demand for payment services, is in many circumstances supply driven.

In terms of supply, electronic methods of payment have certainly increased rapidly in recent times. Witness, for example, the rapid growth in the number of cash dispensers and ATMs installed in the last decade (Graph 5.3). A number of EFTPOS systems are now operational, including PISCES and Clydesdale Bank's Counterplus. CHAPS, an electronic switching system used in high value and urgent payments, is well established. Finally, several home banking services have now been introduced to the market, including the Bank of Scotland's HOBS.

5.3 NUMBER OF CASH WITHDRAWALS FROM CASH DISPENSERS



Source CLSB

The Future

Electronic money transmission services provide a good example of how technological developments may cause overcapacity in banking markets. The key factor is how the new investment influences the critical or breakeven point of a bank's money transmission services.

For the purposes of illustration, envisage a situation where four competitors operate in a market, each with an equal market share and each using the old automated technology. At this stage circumstances cause all four banks to switch to electronic/digital technology. If the critical level of operation for the new technology is one third of the total market then at least one, or possibly all, of the banks no longer break even on their money transmission services. The market is not large enough to support all four systems and overcapacity exists. The market participants are left with the choices of either continuing in a loss making situation, closing down their money transmission services, or co-operating with each other by establishing shared systems. Alternatively, the new critical level may be less than or equal to one quarter of the market, enabling all four banks to cover their costs. However, once one or more of the market participants tries to more fully use their capacity and acquire a larger market share, then the possibility exists that at least one bank will fail to generate sufficient business to break even and overcapacity in money transmission services will have re-established itself.

BARCLAYS PLC
AND
BARCLAYS BANK PLC
ANNUAL REPORT ON
FORM 20-F 1989

BARCLAYS

BARCLAYS PLC
AND
BARCLAYS BANK PLC

ANNUAL REPORT ON FORM 20-F
FOR THE YEAR ENDED DECEMBER 31, 1989

This report is a joint Annual Report on Form 20-F pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Act") filed with the Securities and Exchange Commission, Washington, D.C. 20549, United States of America, by Barclays PLC and Barclays Bank PLC, 54 Lombard Street, London EC3P 3AH, England.

Commission file numbers

Barclays PLC	0-13790
Barclays Bank PLC	2-71497-01

The following securities are registered on the New York Stock Exchange pursuant to Section 12(b) of the Act

Barclays PLC	£1 Ordinary Shares. **American Depositary Shares, each representing four £1 Ordinary Shares.**
Barclays Bank PLC	**Non-cumulative Dollar-denominated Preference Shares.** **American Depositary Shares, each representing one Non-cumulative Dollar-denominated Preference Share.**

There is a reporting obligation for the following securities pursuant to Section 15(d) of the Act

Barclays Bank PLC	**Barclays Bank PLC guarantees relating to the payment of principal, interest and premium (if any) on 11 5/8% Guaranteed Capital Notes due 2003 and 10 1/2% Guaranteed Capital Notes due 2017 of Barclays North American Capital Corporation.**

No securities are registered pursuant to Section 12(g) of the Act.

The number of shares outstanding at December 31, 1989 was

Barclays PLC	**£1 Ordinary Shares**	**1,123,232,848**
	£1 Staff Shares	**875,000**
Barclays Bank PLC	**£1 Ordinary Shares**	**1,708,000,000**
	Non-cumulative Dollar-denominated Preference Shares	**20,000,000**

Barclays PLC **and Barclays Bank** PLC have filed all reports required to be filed by Section 13 or 15(d) of the Act during the **preceding** 12 months, and have been subject to such filing **requirements** for the past 90 days.

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PRESENTATION OF INFORMATION

This report is a joint Annual Report on Form 20-F for Barclays PLC and Barclays Bank PLC. All of the issued Ordinary share capital of Barclays Bank PLC is owned by Barclays PLC. Except where otherwise indicated, the information given in this report is identical with respect to both Barclays PLC and Barclays Bank PLC.

Barclays PLC and Barclays Bank PLC are public limited companies, organised under the laws of England, with their principal office situated at 54 Lombard Street, London.

DEFINITIONS

For the purpose of this report, the term "Barclays PLC Group" means Barclays PLC together with its subsidiary companies and the term "Barclays Bank PLC Group" refers to Barclays Bank PLC together with its subsidiary companies. "Barclays" and "Group" are terms which are used to refer to either of the preceding groups when the subject matter is identical. The term "Bank" refers to Barclays Bank PLC.

The term "Foreign - UK based" refers to activities with overseas customers which are conducted in offices located in the United Kingdom.

CURRENCY OF PRESENTATION

In this report, unless otherwise specified, all amounts are expressed in pounds sterling. For the years indicated, the high, low, average and year-end noon buying rates for cable transfers in New York City, payable in pounds sterling, based on reports issued by the Federal Reserve Bank of New York, were:

	1989	1988	1987	1986	1985
		(US dollars per pound sterling)			
High	1.82	1.91	1.89	1.56	1.49
Low	1.51	1.66	1.47	1.38	1.05
Average (1)	1.63	1.78	1.65	1.47	1.32
Year-end	1.61	1.81	1.89	1.48	1.45

The average of the noon buying rates for cable transfers in New York City on the last day of each month.

On February 20, 1990, the noon buying rate for cable transfers in New York City, payable in pounds sterling, was $1.70 per pound sterling. No representation is made that pounds sterling amounts have been, or could have been, or could be, converted into dollars at that rate or at any of the above rates. For the purposes of presenting financial information in this report, exchange rates other than those shown above may have been used.

BUSINESS DESCRIPTION

Introduction

Barclays is one of the largest diversified banking and financial services groups in the world. Principal activities include retail and corporate banking, investment banking, treasury services, consumer finance and insurance.

Barclays is the largest UK financial group serving the UK domestic market and plays a significant role in the domestic markets of many of the 75 other countries in which it operates. Taking advantage of the products, systems and personnel expertise developed in the United Kingdom and elsewhere, the geographic focus and product mix of the branch banking operations are continually adjusted in the context of changing local market conditions. Increasing differentiation of markets allows a wider range of relevant services to be offered to each customer group and enables the experience gained in one market to be transferred to others where similar opportunities are identified. The larger branch networks now serve distinct personal and corporate markets, with each network providing a range of products suited to its customer base, as well as access to specialist services provided by other Group operations, such as investment banking, insurance and asset backed finance.

The Barclays Group also constitutes one of the major global financial services organisations, providing co-ordinated banking, investment banking and treasury services to multi-national corporations and financial institutions through a network of computer-linked offices in the main financial centres around the world. By drawing on the expertise available within the Corporate Division, Global Treasury Services and Barclays de Zoete Wedd, the Group can supply a complete range of services to world-class organisations seeking either finance or investment opportunities in the global market.

New product development and marketing teams, staff training programmes and continuing investment in information technology, which are designed to improve product delivery and provide the management information needed to identify new market opportunities and manage risk, are features of the underlying development plan.

Branch banking operations

Barclays network of 2,645 UK branches is the principal source of UK revenues and profits. These branches provide a stable base of deposits, provide access to a wide spectrum of customers and enable the Bank to monitor locally the quality of credit relationships. The branches continue to expand their role as a distribution network for financial products and services developed by the Group's other divisions, such as insurance and share dealing services, Barclaycard, travellers cheques and travel services.

The Bank's leading role in the UK retail banking market continues to be enhanced by the development of new products. In January 1989, Barclays announced a new current account package for its seven million UK personal customers involving the elimination of transaction charges on all personal current accounts and the payment of interest on credit balances under two of the three current account options available.

A network of 327 Business Centres deals specifically with the needs of corporate customers. This is the largest such network in the United Kingdom and, with the support of regional business development teams, delivers a comprehensive range of services to business customers. New products are constantly being developed, such as Barclays Business Master which enables corporate customers to access their account information and which, in 1990, will be enhanced to permit customers to make electronic transfers between accounts.

Barclays has also continued to focus on the important small business market. All Business Centres have a manager who concentrates on this market and all branches have Business Bankers who guide small business customers in the establishment and operation of banking facilities. Business Bankers are an important link in the relationship between the Bank and its small business customers, to enable the latter to understand better the range of services available to them.

In the United States, Barclays Bank of New York's 69 branches have been organised into business clusters to concentrate the delivery of services to corporate and high net worth customers. The bank plays a supportive role in the Group's middle market strategy in the United States.

In Europe, Barclays has local branch banking networks in France and Spain and is currently developing its branch network in Portugal. In France, where Barclays is the leading foreign-owned commercial bank, and in Spain, where Barclays Bank SAE has a branch network of more than 200 offices, the focus is on serving both the corporate market and the higher income personal market.

Barclays also has extensive branch banking operations in other overseas markets, the largest being in Africa and the Caribbean.

Central retail services

The Central Retail Services Division ("CRSD") is primarily responsible for the Group's credit card operations including Barclaycard and the gold Premier Card. CRSD also markets lending products to its cardholders, operates a centralised mortgage facility, controls the Group's travellers cheques operations and has diversified into the direct selling of travel services.

With over nine million cardholders at the end of 1989, Barclays is Europe's largest, and the world's second largest, bank issuer of credit cards. Membership of both the Visa and Mastercard payment systems has allowed CRSD to offer customers further card products and to enhance its position of market leadership, now processing over half of all Visa and Mastercard transactions for retailers in the United Kingdom.

As part of the Group's strategy to extend card based activities in Europe, Barclays has acquired a controlling interest in a small card issuing and processing company based in Hamburg, West Germany.

In August 1989, the report of the Monopolies and Mergers Commission on the supply in the United Kingdom of certain credit card services (including Barclaycard) was published. This report contained two major recommendations: first, that certain rules of Visa and Mastercard/Eurocard which restrict the freedom of credit card issuers to act as merchant acquirers should not apply in the United Kingdom and, second, that credit card issuers should cease to require merchants in the United Kingdom to charge the same price for purchases made with credit cards as for those paid for by cash or other means. The UK Secretary of State for Trade and Industry has accepted both recommendations and intends to implement them. In addition, he has said that credit card issuers will have to provide the Director General of Fair Trading with information on the range of charges to retailers and other card issuers and to publish other similar information on their current charges. It is not expected, however, that the implementation of the recommendations will have a material adverse effect on consolidated net income and shareholders' equity of the Group.

Financial services

Barclays Financial Services Limited ("BFS") is principally engaged in insurance broking, the underwriting of life assurance and pension policies, personal investment portfolio management, the management of unit trusts, trust administration and personal tax advice. Specialist operations market these products and services principally through a network of regional offices in the United Kingdom, working in conjunction with the Bank's domestic branch network.

Through Barclayshare, Barclays Retail Investment Management Limited ("BRIM") provides UK customers with non-certificated stockbroking services and access to the market-making and research capabilities of Barclays de Zoete Wedd, the Group's investment bank. BRIM also offers portfolio management and stockbroker clearing and settlement facilities.

Barclays Global Securities Services offers global and personal securities custody, company registration and new issues and corporate trustee services. In 1989, it acquired Hill Samuel Registrars and Ravensbourne Registration Services to establish itself as the third largest registration business in the United Kingdom. The securities services business now serves over three million customers, with $75 billion of assets in custody.

Consumer and business finance

The Barclays Group is one of the world's largest suppliers of consumer and business finance services, providing lending, leasing and asset backed finance. These financial products are provided through the Mercantile Group based in the United Kingdom, BarclaysAmericanCorporation and Barclays Business Credit in the United States and a network of finance companies in most countries of continental Europe.

Treasury services

Global Treasury Services ("GTS") operates from 17 centres around the world, the most important being in London, New York and Tokyo. In December 1989, the London treasury operation moved to a new custom-built trading room, where it plays a major role in financial markets as one of the largest sterling dealers, investing funds for trading, hedging and regulatory purposes. In addition, Barclays has one of London's largest foreign exchange operations which, by linking to other GTS dealing centres, provides a 24-hour dealing service in more than 70 currencies. Other services relate to negotiable instruments, spot and forward foreign exchange, eligible bills and currency deposits. The three major centres support the remainder of the GTS network and the global key network branches in providing currency and interest rate options, floors and caps, distribution of securitised debt, swaps and similar treasury products. This enables the Group to deliver sophisticated treasury products to its customers globally and, at the same time, control the risks by restricting the number of offices which manage the positions created.

Large corporate and international banking

Barclays Corporate Division has units in London, New York, Tokyo, Paris, Frankfurt, Amsterdam, Madrid, Milan, Sydney and Brussels, which are responsible for the delivery of services from all parts of the Barclays Group to large corporate and financial institutions.

Teams based in London, New York and Paris deal specifically with various industry sectors, such as commodities, insurance, aerospace, shipping and high technology, and provide specialist services, such as acquisition finance, syndications and export and project finance.

The UK Corporate Division works closely with the global key network of branches, enabling them to provide a comprehensive range of short, medium and long-term lending instruments. The Group is amongst the leaders in providing multi-option finance packages, semi-recourse and project finance and a variety of leasing facilities, including cross-border instalment credit.

The US Banking Division, with operations centred in New York, plays an important role in the global key network. Through banking offices in 10 states, it serves the global financing needs of US based large and middle market customers. Areas of emphasis include acquisition and corporate finance, credit enhancement programmes, private placements, asset sales and syndications and asset backed finance.

Operations in financial centres throughout Europe, the Far East and Australia complete the network. Principal activities of these centres include project finance, capital market products origination and distribution, leasing and syndication.

Sovereign cross-border lending, including lending to borrowers in countries experiencing liquidity problems, is centralised within the International Banking Group ("IBG") in London. IBG is also responsible for enhancing Barclays relationship with more than 4,000 correspondent banks world-wide. Within IBG a Financial Institutions Group is being formed to bring more focus to the Barclays Group's business with a broad range of financial institutions including banks, investments banks, securities companies, insurance companies and building societies.

Investment banking

The Group's investment banking arm, Barclays de Zoete Wedd ("BZW"), was formed in 1986 and now ranks as one of the principal UK based international investment banks. The inclusion of BZW in the global network enables the Group to provide investment banking services to corporate and institutional clients.

The development of global capability in the research, origination, sales and trading of debt and equity securities is central to BZW's strategy for expansion. To this end, representation in major overseas markets has been increased, notably in Japan, the United States, Canada, Hong Kong, Australia, France, Spain and The Netherlands. Additional strength is provided through close co-operation with Barclays other international operations which are active in securities and investments.

In the United Kingdom, BZW plays a major role in the sterling debt markets, including those for bonds and sterling commercial paper and is one of the principal participants in the market for British Government securities (the gilt-edged market). In late 1989, Barclays de Zoete Wedd Government Securities Inc. became a primary dealer in US Treasury securities. BZW also deals actively in the government bonds of Japan, Germany, France and Holland and has a growing interest rate swap book.

In equities markets, BZW is one of the principal market makers and research houses in Europe. Research covers over 1,400 companies in 18 countries and over half of the division's personnel are dedicated to non-UK activities.

BZW's corporate finance services include capital-raising, secondary offerings, floatations, London listings, acquisitions, mergers, disposals and general corporate advice, together with full treasury and security-related foreign exchange facilities.

Barclays de Zoete Wedd Futures Limited is a member of the London International Financial Futures Exchange and the International Commodities Clearing House and provides broking, clearing and research services in financial futures and options to clients.

BZW's banking division and development capital arm focus principally on the development of innovative financial techniques and tailored financial packages, covering such areas as project finance, acquisition finance, buy-outs and the provision of equity capital for private companies.

BZW's investment management division has steadily increased funds under management internationally. This is reflected in both actively managed and index tracking funds which, at the end of 1989, totalled approximately £18 billion.

Competition

Barclays traditional competitors in branch banking are the other major clearing banks and the building societies in the United Kingdom and local banks in overseas locations. In response to increasing competition from building societies and other banks for retail deposits, Barclays has launched a series of new deposit products in recent years and, in 1989, revised its personal current account package by removing transaction fees and providing new interest bearing current accounts.

The UK market for credit card services has been increasingly competitive in recent years with the entry of many new card issuers including banks, building societies and retail chains. In addition, the acquisition of dual membership of Visa and Mastercard by the major UK banks has increased competition for merchant business.

Deregulation and globalisation of the world's financial markets have not only opened up new areas of opportunity for Barclays, most notably in the formation of BZW and entry into the investment banking business, but have also brought new and intensifying competition. Both in the United Kingdom and overseas, these influences have resulted in an increasingly competitive environment, particularly in the corporate market where the major international banks are seeking to provide ever more sophisticated services to their customers. Barclays has responded by building an integrated corporate banking, treasury and investment banking service through an increasing number of offices in the financial centres of the world.

BZW has developed as a major force among the UK investment banks and has a presence in most of the world's main financial centres, where it faces strong competition from the principal international investment banks.

The development of a single market within the European Community by 1992 will intensify competition, but will also provide further opportunities for Barclays to sell its services within continental Europe, where the Group is represented in each of the twelve member countries.

Recent developments

In February 1990, the Group sold its 32% holding in Yorkshire Bank PLC to National Australia Bank for £312 million. The sale is not reflected in the accompanying financial statements which, in 1989, include £36 million in respect of the Group's share of income before taxes of Yorkshire Bank PLC and £112 million in respect of its net assets including long-term debt, at December 31, 1989. The profit arising on the sale will be included in the 1990 financial statements as an extraordinary item.

An Extraordinary General Meeting of the shareholders of Barclays Bank PLC, held on February 28, 1990, approved the issue of 255 million Ordinary Shares of £1 each to Barclays PLC, representing primarily the capitalisation of part of the amounts arising on the revaluation of property owned by the Bank and a subsidiary company.

At an Extraordinary General Meeting of the shareholders of Barclays PLC to be held on March 20, 1990, a Resolution will be proposed to authorise the Directors to effect a capitalisation issue of two new Ordinary Shares for every five Ordinary Shares held at the close of business on May 11, 1990. As a result, existing reserves, including £449 million arising on the revaluation of property owned by subsidiary companies, would be capitalised.

At the Barclays PLC Annual General Meeting on April 26, 1990, a Resolution will be proposed to enable Barclays PLC to purchase its own Ordinary Shares in the market, up to a fixed maximum, in order to provide additional flexibility in the management of the Group's capital resources. The Directors have no immediate intention of using such authority, if granted, and would only do so if satisfied that such action was in the interests of shareholders and would lead to an increase in the Group's earnings per share.

SELECTED FINANCIAL DATA

The sterling financial information given below for the years 1985 to 1989 has been selected from the audited financial statements of Barclays PLC and Barclays Bank PLC for the last five years, restated where appropriate to accord with current accounting practice. This information should be read in conjunction with, and is qualified by reference to, the financial statements and notes included in this report. The dollar financial information has been translated for convenience at the rate of $1.61 to £1, the noon buying rate for cable transfers in New York City payable in pounds sterling, at December 31, 1989.

The following financial information has been prepared in accordance with accounting principles generally accepted in the United Kingdom ("UK GAAP").

Financial data prepared under UK GAAP

Selected Income Statement Data	1989 $	1989 £	1988 £	1987 £	1986 £	1985 £
			(million)			
Net interest income	5,506	3,420	2,966	2,671	2,475	2,331
Other operating income	3,424	2,127	1,785	1,550	1,284	1,103
Operating expenses	5,715	3,550	3,155	2,848	2,498	2,252
Provision for lending losses	2,249	1,397	301	1,072	416	415
Share of income before taxes of associated companies	148	92	96	68	75	74
Income before taxes	1,114	692	1,391	369	920	340
Net income (i) (ii)						
- Barclays PLC Group	728	452	887	204	649	440
- Barclays Bank PLC Group	747	464	887	204	649	440
Selected Balance Sheet Data						
Shareholders' equity and minority interests	10,743	6,673	5,827	4,298	3,876	3,274
Undated capital notes	2,125	1,320	996	954	1,215	836
Long-term debt	2,491	1,547	1,507	1,620	1,308	1,259
Total capital resources	15,359	9,540	8,330	6,872	6,399	5,369
Deposits and other borrowings	167,128	103,806	87,034	73,861	65,313	55,977
Advances and other accounts	151,733	94,244	78,179	64,154	57,574	50,591
Total assets	205,462	127,616	104,645	87,855	79,002	65,104
Selected Financial Statistics	(cents)	(pence)	(pence)	(pence)	(pence)	(pence)
Barclays PLC Group						
Net income per £1 Ordinary Share (iii)	65.0	40.4	87.8	24.4	80.9	58.8
Dividends per £1 Ordinary Share (iii)	44.1	27.4	23.0	19.9	18.0	16.0
Book value per £1 Ordinary Share (iii)	892	554	513	488	469	407
	(%)	(%)	(%)	(%)	(%)	(%)
Net income as a percentage of:						
average total assets	0.38	0.38	0.94	0.25	0.91	0.68
average shareholders' equity	7.43	7.43	17.59	5.19	18.68	15.42
Dividends as a percentage of net income	68.14	68.14	28.86	83.82	22.34	29.09
Average shareholders' equity as a percentage of average total assets	5.13	5.13	5.34	4.79	4.88	4.43
Barclays Bank PLC Group						
Net income as a percentage of:						
average total assets	0.39	0.39	0.94	0.25	0.91	0.68
average shareholders' equity	7.42	7.42	17.59	5.19	18.68	15.42
Average shareholders' equity as a percentage of average total assets	5.28	5.28	5.34	4.79	4.88	4.43

The following financial information has been adjusted from data prepared under UK GAAP to reflect significant differences from accounting principles generally accepted in the United States ("US GAAP") (iv)

Financial data adjusted to reflect US GAAP

Selected Financial Data	1989 $	1989 £	1988 £	1987 £	1986 £	1985 £
			(million)			
Net income						
- Barclays PLC Group	483	300	784	186	543	565
- Barclays Bank PLC Group	502	312	784	186	543	565
Shareholders' equity						
- Barclays PLC Group	8 810	5 472	5 305	3 791	3 543	3 118
- Barclays Bank PLC Group	9 069	5 633	5 171	3 714	3 469	3 060
Total assets	208 447	129 470	107 029	89 667	91 183	56 226
Selected Financial Statistics	(cents)	(pence)	(pence)	(pence)	(pence)	(pence)
Barclays PLC Group						
Net income per £1 Ordinary Share (iii)	43.1	26.8	77.6	22.2	67.7	75.5
Dividends per £1 Ordinary Share (iii)	39.3	24.4	20.9	18.9	16.9	14.5
Book value per £1 Ordinary Share (iii)	784	487	476	442	440	390
	(%)	(%)	(%)	(%)	(%)	(%)
Net income as a percentage of						
average total assets	0.25	0.25	0.81	0.22	0.75	0.86
average shareholders' equity	5.45	5.45	16.89	5.14	16.72	21.61
Dividends as a percentage of net income	91.00	91.00	26.15	83.87	25.05	18.41
Average shareholders' equity as a percentage of average total assets	4.56	4.56	4.81	4.30	4.47	3.99
Barclays Bank PLC Group						
Net income as a percentage of						
average total assets	0.26	0.26	0.81	0.22	0.75	0.86
average shareholders' equity	5.64	5.64	17.28	5.25	17.06	22.05
Average shareholders' equity as a percentage of average total assets	4.59	4.59	4.70	4.21	4.38	3.91

Notes:

After extraordinary surpluses of £3 million in 1985 and £21 million in 1986 on the reduction of holdings in subsidiary and associated companies.

The difference between Barclays PLC Group and Barclays Bank PLC Group net income arises from dividend payments on Preference Shares issued by Barclays Bank PLC in 1989, accounted for as a minority interest in the Barclays PLC Group.

(iii) Restated for earlier years to reflect the rights issue in 1988.

(iv) Net income and shareholders' equity have been adjusted for significant differences between UK and US GAAP as shown in note 30 to the financial statements. Total assets have been adjusted for such differences and also to include acceptances.

(v) Over one third of Barclays consolidated assets is denominated in currencies other than sterling (principally in dollars) and the trends shown above, particularly in respect of balance sheet items, have been affected by exchange rate movements (see "Currency of Presentation" on page 2).

FINANCIAL REVIEW

INCOME	1989	1988 (£ million)	1987
United Kingdom			
UK domestic banking and treasury operations	1 030	773	548
Central Retail Services Division	42	99	97
Financial Services Division	165	104	86
Barclays de Zoete Wedd Group	54	33	(11)
Mercantile Group	51	91	85
UK associates	69	84	50
Total United Kingdom	1 411	1 184	855
Foreign			
Foreign - UK based treasury and banking operations	(873)	88	520
United States	72	43	64
Rest of the World	82	76	30
Total Foreign	(719)	207	486
Income before taxes and minority interests ("income before taxes")	692	1 391	369

ASSETS	1989	1988	1987
United Kingdom			
UK domestic banking and treasury operations	60.945	53.429	41 252
Central Retail Services Division	3.372	3.181	2 377
Financial Services Division	283	204	162
Barclays de Zoete Wedd Group	6.655	4.504	4 676
Mercantile Group	6.994	6.490	5.259
UK associates	214	197	155
Total United Kingdom	78.463	68.005	53 881
Foreign			
Foreign - UK based treasury and banking operations	10.082	7.874	8.740
United States	16.254	12.794	11.035
Rest of the World	22.817	15.972	14.199
Total Foreign	49.153	36.640	33.974
Total assets	127.616	104.645	87.855

CAPITAL RESOURCES	1989	1988	1987
Shareholders' equity and minority interests	6.673	5.827	4.298
Undated capital notes	1.320	996	954
Long-term debt	1.547	1.507	1.620
Total capital resources	9.540	8.330	6.872

INTRODUCTION

	1989	1988	1987
		(£ million)	
Income before taxes and country risk provisions	1,675	1,401	1,109
Country risk provisions	(983)	(10)	(740)
Income before taxes	692	1,391	369

Income before taxes and country risk provisions grew by 20% in 1989, following a 26% increase in 1988.

In the United Kingdom, the domestic banking and treasury operations made by far the largest contribution to the Group's results, increasing income before taxes by £257 million (33%) in 1989, following a £225 million (41%) growth in 1988. This was again mainly a result of increased lending volumes. The Financial Services Division achieved a 59% profit advance, with substantially higher sales of pension and life assurance products. Profit declines in Central Retail Services Division and Mercantile Group resulted from increased competition and higher funding costs.

The Group's foreign operations showed improvements, particularly in the United States, Europe, Africa and the Caribbean, but higher provisions resulted in significant losses in Australasia.

The underlying improvement in the Group's operating results was adversely affected by further provisions during 1989 of £983 million in respect of lendings to borrowers in countries experiencing liquidity problems. These country risk provisions, resulting in a 50% decline in Group income before taxes in 1989, brought the country risk allowance for developing countries to £1 228 million (70% of exposure) and that for developed countries to £305 million (41% of exposure). Barclays has now raised a 100% allowance in respect of 19 of the 26 developing countries to which it has country risk exposure.

Total Group assets increased by 22% in 1989 and by 19% in 1988, reflecting, in particular, growth in the UK domestic bank's lending, the expansion of the trading assets of the securities business and, in 1989, increased placings with other banks. Movements in exchange rates had the effect of increasing the reported assets of foreign operations by approximately £4 billion in 1989, in contrast to 1988 when they had little effect.

Capital resources increased by 15% during 1989 leaving the Barclays PLC Group's risk asset ratio at 9.0%, with a Tier 1 ratio of 5.7%. In 1988, the Group's capital position improved by 21%, mainly as a result of a rights issue of £920 million.

ANALYSIS OF INCOME BEFORE TAXES BY AREA OF OPERATION

UK domestic banking and treasury operations	1989	1988	1987
		(£ million)	
	1,030	773	548

Increased lending was the principal reason for the growth in the income before taxes of the UK domestic banking and treasury operations in both 1988 and 1989. The lending growth in 1989 was mainly in the corporate sector, in contrast to 1988 when home mortgage lending was a major area of expansion.

While the lending growth has continued to increase net interest income, the interest rate spread has narrowed as a result of pressure on lending margins, particularly on home mortgages. This was partially offset by the continuing success of the Bank's branch based deposit products which reduced the proportion of more expensive wholesale funds in the deposit mix.

In January 1989, the Bank introduced new interest bearing current accounts and eliminated personal account transaction charges, which had contributed £88 million in 1988. Despite this, UK branch commission income still grew by 3% because of strong growth in lending fees and in charges for other customer services. Overall, the cost of introducing the new current account has remained in line with the Bank's original estimates.

Control of expenses, including a reduction in staff numbers, also benefited the results. However, against the background of substantial growth in lendings over the last two years, provisions for lending losses increased in 1989, largely because of the impact of high interest rates and a less favourable economic climate.

The results for 1989 benefited from a full year's use of the funds raised by the rights issue in mid-1988 and from higher interest rates available on the deployment of those funds.

In view of the likelihood that UK economic growth will be relatively slow in 1990, the balance sheet is expected to grow at a lower rate than in 1989.

Central Retail Services Division ("CRSD")

	1989	1988	1987
		(£ million)	
	42	99	97

The 58% decline in CRSD's income before taxes in 1989 was largely the result of reduced net interest income from credit card operations. Funding costs increased substantially in the second half of 1988 and in 1989 and competition from a growing number of new card issuers restricted compensating increases in interest rates charged on credit card lendings. Despite higher transaction volumes, interest earning lendings showed little growth, as customers have increasingly paid off their balances within the interest free grace period. In addition, the launch of new card products has involved significant costs, while the more difficult economic conditions experienced in 1989 have given rise to increased provisions for lending losses.

Notwithstanding the continuing growth in the turnover of the merchant service operation, intense competition following the acquisition of dual Visa/Mastercard membership by all the major UK banks, has reduced merchant charge rates and this has also adversely affected profits.

The results of the consumer lending and centralised mortgage activities were also reduced as a result of increased funding costs and the economic slow-down in the United Kingdom. Although small by comparison, the travel service and currency operations made a significantly increased contribution to the Division's results.

The recommendations of the Monopolies and Mergers Commission study of the credit card industry, which was released in August 1989, and subsequent pronouncements by the Secretary of State for Trade and Industry, are not expected to have a material adverse effect on the Group's results. (See "Business Description".)

Financial Services Division

	1989	1988	1987
		(£ million)	
	165	104	86

The 59% increase in income before taxes of the Financial Services Division arose essentially from strong growth in sales of life assurance and pension policies, which also provided the embedded value contribution to profit of £69 million (1988 £50 million, 1987 £30 million). (See note 1(e) to the financial statements.)

The rise in interest rates since mid-1988 has had a favourable impact on interest earnings, but has depressed the UK housing market and this led to a decline in the sale of mortgage related products. In contrast, sales of insurance products related to consumer finance continued to expand.

The results have also benefited from increased unit trust sales and investment management fees, reflecting a recovery in investor sentiment over the last two years, and from a rationalisation and cost control programme.

Barclays de Zoete Wedd Group ("BZW")	**1989**	**1988**	**1987**
		(£ million)	
	54	33	(11)

The BZW Group's income before taxes increased by 64% in 1989 despite the continuing difficult trading conditions and further investment in the development of its international network.

The equities division made a significant contribution to profit in 1989. This contrasts with losses sustained in 1987, and to a smaller extent in 1988, as a result of the stock market decline in October 1987 and the subdued market activity which followed.

The merchant banking and asset management divisions also increased their earnings in 1989. The fixed income division substantially increased revenues, but suffered a provision of £32 million which was raised during the year in respect of interest rate swaps with UK local authorities, some of which have been judicially determined by the Court of Appeal to be unlawful (see "Legal Proceedings"). However, this provision was broadly offset by profits arising in the development capital business on the sale of part of BZW's investment in NFC (formerly National Freight Consortium).

Mercantile Group	**1989**	**1988**	**1987**
		(£ million)	
	51	91	85

Income before taxes fell by 44% in 1989 mainly as a result of lower profits in the consumer lending division which was adversely affected by intense competition and increased funding costs. These effects were tempered by reduced provisions for lending losses. The vehicle hiring operations also recorded lower profits. The business lending division expanded its activity in all sectors of its corporate market and maintained its level of profitability. A profit of £28 million, arising from the sale of motor distribution businesses, was largely offset by the cost of relocating Mercantile Group's headquarters from London to Basingstoke.

UK associates	**1989**	**1988**	**1987**
		(£ million)	
	69	84	50

The principal UK associates are Yorkshire Bank PLC, a UK regional bank, and 3i Group Plc, a UK venture capital company. The 1988 results benefited substantially from £19 million profit earned from the sale of an investment in British Caledonian Airways by 3i Group.

In 1989, the profit contribution from Yorkshire Bank was £36 million (1988 £32 million). In February 1990, the Group sold its holding in Yorkshire Bank PLC to National Australia Bank for £312 million.

Foreign - UK based treasury and banking operations	**1989**	**1988**	**1987**
		(£ million)	
Before country risk provisions	110	98	120
Country risk provisions	(983)	(10)	(740)
After country risk provisions	(873)	88	(620)

Further deterioration in the economic and political condition and debt service performance of countries experiencing liquidity problems during 1989 led to additional provisions for lending losses of £983 million. While only a small additional provision, to cover outstanding interest, was charged during 1988, a provision of £740 million was raised in 1987 reflecting an industry-wide reappraisal of the third world debt problem at that time. The country risk provisions raised in 1989 include £72 million provided against interest arrears and losses of £79 million on the sale of £482 million of country risk loans.

Foreign - UK based treasury, money market and foreign exchange operations continued to perform at a level comparable to previous years.

United States	**1989**	**1988**	**1987**
		(£ million)	
	72	43	54

The US profits improved 67% over those of 1988 as a result of strong growth in operating income across all operations.

The US Banking Division, which now includes certain of the former operations of BarclaysAmericanCorporation (BAC), achieved significant gains in net interest income and commissions, partly offset by higher provisions against lending losses. BAC also improved operating income and, with a substantial reduction in provisions for lending losses compared with 1988, returned to profit in 1989.

The 1988 result included a profit of £20 million arising from the sale of Barclays Bank of California.

In November 1989, BAC agreed, subject to regulatory approval, to sell its consumer finance division at a price equal to book value plus a premium of $50 million. At December 31, 1989, the book value of the division was $112 million. It is anticipated that the net gain on sale will be included in the 1990 financial statements.

Rest of the World	**1989**	**1988**	**1987**
		(£ million)	
	82	76	70

Income before taxes in the Rest of the World grew overall by 8% in 1989, with the major increases in Europe (up 36%) and Africa and the Caribbean (up 28%), offset by a substantial downturn in Australasia.

In Europe, the main contributions to profit arose in Spain, France and Portugal. The losses sustained in Italy in recent years were much reduced despite a one-off cost associated with its financial restructuring. The overall result for Europe was adversely affected by one large lending loss incurred in West Germany.

The Caribbean operations significantly increased profits as a result of strong balance sheet growth and improved lending margins, while all the main African operations also improved their results.

The Australian operations incurred substantial losses in 1989 and losses continued in New Zealand, although at a lower level than in 1988. Provisions for lending losses arose in both locations as a result of the difficult underlying economic conditions in those countries.

ANALYSIS OF THE STATEMENT OF INCOME

	1989	1988	1987
		(£ million)	
Net interest income	3,420	2,968	2,671
Other operating income	2,127	1,785	1,550

Net interest income continued to grow rapidly, increasing by 15% in 1989, following an 11% increase in 1988. Despite the elimination of transaction fees charged on personal current accounts in the United Kingdom, other operating income grew even more rapidly, up 19% in 1989, following a 15% increase in 1988. A significant percentage of such income is not related to balance sheet growth and reflects the Group's strategy to shift progressively towards less balance sheet intensive sources of income.

Net interest income

Higher levels of lending were again the predominant factor in increasing net interest income, with the average lending book growing by 24% in 1989 and by 20% in 1988. The interest spread has, however, continued to suffer from pressure on lending margins, particularly in the United Kingdom, as it was difficult to raise lending rates in line with rapidly increasing market rates during the second half of 1988 and much of 1989. Improvements have been made in the deposit mix in 1989, with marked success being achieved in raising new savings and retail time deposits. This has reduced the Bank's reliance on relatively more expensive sterling wholesale funds, the greater use of which was a major factor in increasing funding costs in the second half of 1988 and early 1989.

Although higher interest rates increased the benefit derived from the Group's interest free demand deposit base, this benefit was offset by a reduction in these funds, following the introduction of new interest bearing current accounts in the United Kingdom.

Prevailing average interest rates:

		1989	1988	1987
		%	%	%
United Kingdom	Barclays Bank PLC base rate	13.8	10.1	9.7
	London inter-bank offered rate			
	three month sterling	13.9	10.3	9.7
	three month eurodollar	9.3	7.9	7.1
United States	Prime rate	10.9	9.4	8.2

Yields, spreads and margins:

			1989	1988	1987
Gross yield	(i)	Group	12.8	10.7	10.4
		Domestic business	14.5	12.1	12.2
		International business	10.4	8.8	8.4
Interest spread	(ii)	Group	1.9	2.2	2.4
		Domestic business	2.2	2.7	3.1
		International business	1.2	1.3	1.3
Interest margin	(iii)	Group	3.2	3.5	3.6
		Domestic business	4.3	4.7	5.3
		International business	1.9	1.8	1.9

Notes:

(i) Gross yield is the interest rate earned on average interest earning assets.

(ii) Interest spread is the difference between the interest rate earned on average interest earning assets and the interest rate paid on average interest bearing liabilities.

(iii) Interest margin is net interest income as a percentage of average interest earning assets.

Other operating income	1989	1988	1987
		(£ million)	
Commission	1 435	1 283	1 155
Securities trading income	203	145	85
Foreign exchange trading income	172	112	113
Increase in value of long-term assurance policies	69	50	30
Securities (losses) gains	(3)	16	17
Other income	251	179	150
	2 127	1 785	1 550

Other operating income increased by 19% in 1989 and 15% in 1988, with gains in commission being achieved in almost all areas of the Group world-wide. The UK domestic bank was the main contributor in both years, with higher lending fees resulting from the expansion of the domestic lending book. The elimination of transaction fees on personal accounts in 1989 was largely compensated for by increased fees charged for unauthorised overdrafts and other services to customers. Credit card transaction fees earned by Central Retail Services Division also made a significant contribution to commission income in both years.

Securities trading income improved by 40%, principally as a result of increased trading gains in BZW's equities division. The 54% increase in foreign exchange trading income was broadly spread over a number of centres.

The growth in the value of long-term assurance policies reflects the rapid expansion of this business, with the 1989 growth being particularly associated with pensions linked business.

Other income includes significant contributions from the corporate finance and development capital operations of BZW and from the motor distribution activities of the Mercantile Group. In 1989, other income also included a profit of £28 million from the disposal of the Mercantile motor distribution subsidiaries and a similar gain from the disposal of shares in NFC by BZW. In 1988, a profit of £20 million was made on the disposal of Barclays Bank of California.

Operating expenses	1989	1988	1987
		(£ million)	
Staff costs	2 064	1 882	1 676
Property and equipment expenses	626	568	516
Other expenses	860	705	656
	3 550	3 155	2 848
Employees of the Group world-wide at December 31	116,500	118,400	113,200

Operating expenses increased by 13% during 1989 (1988 11%), compared with a 17% increase in total operating income (1988 13%). Staff costs rose by 10% (1988 12%), with salary increases being partly offset by a reduction in employee numbers. Property and equipment expenditure is reported net of the profits made on the disposal of properties of £40 million in 1989 (1988 £27 million, 1987 £9 million), with the underlying increase reflecting the substantial expenditure necessary to maintain and improve the Group's product delivery and information systems. Other expenses in 1989 include relocation costs of £23 million in the Mercantile Group and provisions of £37 million made in respect of interest rate swaps with UK local authorities (see "Legal Proceedings"). Excluding these amounts, other expenses increased by 13%.

The Bank is currently undertaking a review of its operations to cut operating expenses and to increase efficiency and intends to reduce the number of its UK employees by 2,500 over the next few years and to transfer others from processing work to sales and customer service.

Provisions for lending losses

	1989	1988	1987
		(£ million)	
Credit risk provisions	414	291	332
Country risk provisions	983	10	740

Credit risk provisions have increased substantially from the historically low charge recorded in 1988, reflecting the lendings growth in recent years and the impact of continuing high rates of interest on the customer base, particularly in the United Kingdom. The lower provisions recorded in 1988 followed a period of sustained economic growth in the United Kingdom.

The £983 million additional provisions in respect of country risk in 1989 arise from the deteriorating economic and political condition and debt service performance of rescheduling countries. (See "Exposures to countries experiencing liquidity problems".) Provisions include £72 million relating to overdue interest and a £79 million loss incurred on debt sales.

Share of income before taxes of associated companies

	1989	1988	1987
		(£ million)	
	92	96	68

Barclays share of income before taxes of associated companies in 1989 is little changed from the 1988 result which was 41% ahead of 1987. The main contributions in 1989 come from the Bank's share of the profits of 3i Group Plc and Yorkshire Bank PLC. In 1988, a £19 million profit came from the sale by 3i Group of its investment in British Caledonian Airways. In February 1990, the Group sold its holding in Yorkshire Bank PLC.

Applicable taxes

	1989	1988	1987
	%	%	%
Average UK corporation tax rate	35.0	35.0	35.0
Effect of change in level of general allowance	0.9	(2.4)	1.9
Effect of higher tax rates overseas	0.7	0.8	3.5
Release of deferred tax in respect of leasing transactions	(7.8)	-	-
Other items	2.3	2.4	2.7
Effective rate of tax	31.1	35.8	43.1

In 1989, the overall effective rate of tax of 31.1% reflects principally a release in the year of £54 million of deferred taxes, previously provided in respect of leasing transactions, which the Directors now consider will not be payable in the foreseeable future.

Tax relief has been taken in respect of specific provisions against the Group's direct lendings to borrowers in countries experiencing liquidity problems, although the detailed basis has still to be agreed with the Revenue Authorities.

Reconciliation of UK and US GAAP

		1989	1988	1987
			(£ million)	
Barclays PLC Group	- UK GAAP net income	452	887	204
	- US GAAP net income	300	784	186

Barclays Bank PLC Group - Net income is £12 million lower under both UK GAAP and estimated US GAAP because of dividends on Non-cumulative Dollar-denominated Preference Shares.

See note 30 to the financial statements for a reconciliation of net income and shareholders' equity between amounts calculated under UK GAAP and those estimated under US GAAP and for a discussion of future developments in this area. The main items which contributed to lower net income as estimated under US GAAP were deferred taxes, goodwill and long-term assurance policies.

CAPITAL RESOURCES

	1989	1988 (£ million)	1987
Barclays PLC Group			
Shareholders' equity	6 225	5 711	4 187
Minority interests	448	116	111
Undated capital notes	1 320	996	954
Long-term debt	1 547	1 507	1 620
Total capital resources	9 540	8 330	6 872
Barclays Bank PLC Group			
Shareholders' equity	6 536	5 711	4 187
Minority interests	137	116	111
Undated capital notes	1 320	996	954
Long-term debt	1 547	1 507	1 620
Total capital resources	9 540	8 330	6 872

Capital adequacy and the use of capital are monitored by the Group and individual operating units employing techniques based on the guidelines developed by the Basle Committee on Banking Regulations and Supervisory Practices ("the Basle Committee") now implemented by the Bank of England for supervisory purposes.

During 1989, total capital resources increased by £1 210 million. The issue, by Barclays Bank PLC, of 20 million Non-cumulative Dollar-denominated Preference Shares added £311 million to the shareholders' equity of the Bank and has been included within minority interests in Barclays PLC Group. The Bank also raised £200 million of Undated Floating Rate Primary Capital notes. A property revaluation at the year end provided a surplus of £242 million and movements in exchange rates added a further £353 million to capital resources. Retained income for the year added £144 million.

The Non-cumulative Dollar-denominated Preference Shares raised by Barclays Bank PLC during 1989 rank as "Tier 1" capital for convergence risk asset ratio purposes and contribute to the hedging of the Group's capital ratios against exchange rate movements.

During 1988, gross capital resources increased by £1 458 million, the key components being the £920 million proceeds of the rights issue and retained earnings of £631 million. Long-term debt of £141 million was repaid during the year.

Capital ratios

The Bank of England, in common with other bank supervisors, regards the risk asset ratio developed by the Basle Committee as a key supervisory tool. This ratio was designed to meet the dual objectives of strengthening the soundness and stability of the international banking system and of creating a fair and consistent supervisory framework for international banks by means of an international convergence of capital measurement and capital standards. The technique involves the application of weightings to both balance sheet assets and off-balance sheet items ("risk assets") to reflect the credit and other risks associated with broad categories of counterparty.

The Basle Committee intends that all international banks should meet a minimum risk asset ratio of 8% by the end of 1992, with a lower interim standard to be met by the end of 1990. The Bank of England has already implemented the new standards, requiring that individually set minimum risk asset ratios be met by banks within its jurisdiction, without recourse to the interim standard.

The risk asset approach to capital adequacy emphasises the importance of "Tier 1" (core) capital, comprising mainly shareholders' equity, and limits the use of "Tier 2" (supplementary) capital, which includes fixed asset revaluation reserves, subordinated debt and the general allowance for lending losses.

The following table analyses capital resources at December 31, 1989 in accordance with supervisory requirements. By agreement with the Bank of England, the assets, capital and liabilities of the UK securities trading subsidiaries, which are regulated by another UK supervisor, are excluded from this calculation.

	Barclays PLC Group	**Barclays Bank PLC Group**
	(£ million)	
Tier 1		
Shareholders' equity (excluding fixed asset revaluation reserves)	5,358	5,879
Minority interests	373	62
Total Tier 1 capital	5,731	5,941
Tier 2		
Fixed asset revaluation reserves	867	657
Subordinated term debt and other hybrid capital instruments (i)	2,851	2,851
Minority interests	75	75
	3,793	3,583
General allowance for lending losses	218	218
Total Tier 2 capital	4,011	3,801
Gross capital resources	9,742	9,742
Less investments in associated companies and other supervisory deductions (ii)	650	650
Total net capital resources	9,092	9,092

Notes:

(i) Term and perpetual debt are included in supplementary capital, subject to limits laid down in the guidelines. Barclays retains capacity to raise a substantial amount of supplementary capital within those limits.

(ii) Including embedded value of £147 million related to long-term assurance policies.

Capital ratios (continued)

The concept of risk weighting assumes that banking activities generally involve some risk of loss. The technique agreed by the Basle Committee, is intended to gauge the degree of risk associated with different types of transaction and categories of counterparty. For this purpose commercial lendings are taken as a benchmark to which a risk weighting of 100% is ascribed. Other transactions, which are considered to generate lower levels of risk than commercial lending, may qualify for reduced weightings.

Thus, credit substitutes, such as standby letters of credit and acceptances, are allocated the same risk weighting as similar on-balance sheet lendings while transaction related contingents, such as performance bonds, are allocated a lower weighting in recognition of the lesser likelihood of loss from these instruments.

In the case of interest and exchange rate related contracts the principal amounts are not considered to be at risk. The risks involved relate to the replacement cost of these contracts arising from movements in market rates.

At December 31, 1989, Barclays risk assets comprised:

	Face, contract or notional amount	Risk weighted
	(£ million)	
On-balance sheet assets	125.622	83.455
Off-balance sheet items (i)		
Credit substitutes	8.910	6.679
Trade and transaction related contingents	6.039	2.802
Undrawn loan commitments (ii)	10.965	5.294
Interest and exchange rate related contracts (iii)	213.600	1.546
Other off-balance sheet items	42.005	1.598
Total	407.141	101.174

Ratios	**Barclays PLC Group**	**Barclays Bank PLC Group**
	%	%
Risk asset ratio	9.0	9.0
Tier 1 ratio	5.7	5.9

After taking into account the sale of Yorkshire Bank PLC, completed in February 1990, the capitalisation issue in the Bank and proposed capitalisation issue in Barclays PLC (see "Business Description - Recent developments"), the risk asset ratios of both Barclays PLC Group and Barclays Bank PLC Group, on a pro-forma basis, would be 9.2%. The Tier 1 ratios, calculated on an equivalent pro-forma basis, would be 6.2% and 6.3% respectively.

Notes

(i) Off-balance sheet items are converted to credit risk equivalents by applying credit conversion factors laid down by the Basle Committee. The resultant amounts are then risk weighted according to the nature of the counterparty.

(ii) Undrawn loan commitments with a maturity of less than one year or which are unconditionally cancellable at any time are given a risk weighting of nil and have been included in other off-balance sheet items.

(iii) The Basle Committee guidelines require an assessment of the amounts at risk in respect of interest and exchange rate related instruments, arrived at by calculating the replacement cost at current market rates of all contracts where counterparty failure would result in loss. A further factor is then required to be added, representing potential increases in the amounts at risk arising from future movements in interest and exchange rates during the remaining lives of the contracts, and the resultant amounts are risk weighted according to the nature of the counterparty.

SECURITIES

The following table analyses the book value of securities (excluding securities trading assets)

	December 31		
	1989	1988	1987
		(£ million)	
UK Government	573	786	1 104
US Treasury and other US Government agencies and corporations	405	269	309
States of the United States and political subdivisions	12	10	14
Other securities	948	705	929
	1 938	1 770	2 356

Other securities comprise mainly government securities of countries in which Barclays operates.

The following table analyses the maturities and weighted average yields of securities at December 31, 1989

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	(Amount : £ million)							
	Amount	Yield %	Amount	Yield %	Amount	Yield %	Amount	Yield %
UK Government	21	11.4	342	11.8	167	10.8	43	11.0
US Treasury and other US Government agencies and corporations	16	8.4	301	7.8	57	7.5	31	9.0
States of the United States and political subdivisions	12	8.8	-	-	-	-	-	-
Other securities	230	10.4	417	8.5	95	7.5	206	11.4
	279	10.3	1 060	9.3	319	9.2	280	11.1

The weighted average yield for each range of maturities is calculated by dividing the annual interest income prevailing at December 31, 1989 by the book value of securities held at that date. Yields on certain US securities, which are exempt from taxation, have been calculated using interest income adjusted to reflect a taxable equivalent basis.

LENDINGS

Lendings consist of loans, overdrafts and finance lease receivables. A combination of these facilities is often provided, particularly to corporate customers.

The geographical analyses of lendings presented in this section are based on the location of the office from which the lendings are made.

The overdraft system

At December 31, 1989, approximately 20% of the Group's lendings in the United Kingdom was in the form of overdrafts. The overdraft system provides a demand credit facility combined with a current account. Overdrafts occur whenever the customer's drawings take the account into debit. The balance fluctuates with the requirements of the customer. Although overdrafts are contractually repayable on demand (unless a fixed term has been agreed), provided the account is operated within established borrowing limits, full repayment is not generally demanded.

Analysis of the lendings portfolio

The following tables analyse lendings, excluding finance lease receivables, by maturity and interest rate sensitivity, at December 31, 1989. The United States analysis excludes loans secured by family residences and consumer instalment loans.

In the maturity analysis, overdrafts are included in the "Less than one year" category.

	United Kingdom		United States		Rest of the World		Total	
			(Amount : £ million)					
	Amount	%	Amount	%	Amount	%	Amount	%
Lendings by maturity								
Less than one year	26,549	48	3,322	44	6,817	68	36,688	51
One year to five years	12,150	22	2,763	37	1,985	20	16,898	23
Over five years	16,473	30	1,433	19	1,273	12	19,179	26
	55,172	100	7,518	100	10,075	100	72,765	100
Interest rate sensitivity of lendings								
Fixed rate	9,383	17	1,899	25	4,831	48	16,113	22
Variable rate	45,789	83	5,619	75	5,244	52	56,652	78
	55,172	100	7,518	100	10,075	100	72,765	100

The following tables analyse lendings by type of customer, at December 31, for the years indicated. The UK and US analyses are based mainly on the requirements of the respective regulatory authorities.

	1989	1988	1987 (£ million)	1986	1985
Lendings in offices in the United Kingdom					
Customers domiciled in the United Kingdom					
Loans guaranteed by Export Credits Guarantee Department	659	690	848	883	892
Central and local government and government-owned corporations	105	268	232	399	477
Manufacturing	6 960	5.186	4 586	3 776	3 592
Construction	2 910	2.300	1 385	1 024	1 225
Finance	2 809	2.421	1 570	1 522	1 432
Service industries	12 214	10.018	7 450	5 475	4 419
Agriculture, forestry and fishing	1 675	1 559	1 365	1 296	1 425
Property	4 493	3 195	2 140	1 197	1 058
Other businesses	926	800	371	331	40
Individuals: Home mortgages	8 278	7 960	5.275	3 522	3 088
Other	10.246	9 357	7 928	6 786	6 014
Overseas customers	3.897	3.524	3 227	3 485	3 472
	55.172	48 278	36 377	29 696	27 134
Finance lease receivables	3 412	3 250	2 620	2 419	2.414
	58 584	51 528	38 997	32 115	29 548
Lendings in offices in the United States					
Commercial and industrial	4 863	3.680	3 280	3.937	3 517
Mortgage and real estate					
Secured by family residences	824	585	443	465	394
Other	1.809	1.307	899	1.015	734
Consumer instalment loans	1.096	1 028	1.084	1 330	1 122
All other loans	846	833	1.258	951	647
	9.438	7.433	6.964	7.698	6.414
Finance lease receivables	198	147	118	162	145
	9.636	7.580	7.082	7.860	6.559
Lendings in offices in the Rest of the World					
Loans and overdrafts	10.075	7.517	6.518	6.528	5 699
Finance lease receivables	773	615	498	398	323
	10.848	8.132	7.016	6.926	6.022
Total lendings	79.068	67.240	53.095	46.901	42.129

Lendings (continued)

Barclays lendings are widely dispersed over customer categories within the United Kingdom, the main area of operations, and are also well spread geographically outside the United Kingdom, thus reducing credit and country risk. No one concentration of lendings, with the exception of home mortgage lending in the United Kingdom, accounts for more than 10% of Group lendings and no individual country, other than the United Kingdom and the United States, accounts for more than 5% of Group lendings.

In the normal course of its business, the Group makes, and participates in, lendings to finance acquisitions, recapitalisations and leveraged buyouts that result in a higher debt to equity ratio for the borrower. To the extent that, in these circumstances, the borrower's debt to total assets ratio exceeds 75% or the transaction at least doubles the borrower's liabilities and results in a leverage ratio higher than 50%, and the total original financing package exceeds $20 million (£12.5 million), such lendings are generally classified by US bank regulators as highly leveraged transactions. In the context of this classification, Barclays estimates that, at December 31, 1989, it had aggregate outstandings of approximately £1.4 billion in 160 such highly leveraged transactions and had further firm commitments to lend approximately £1 billion in 110 such transactions. As with all lendings, before granting the credit, the Group considers the circumstances under which such lendings are made, including geographic and industry concentration, length of maturity, use of interest protection mechanisms, additional borrowing restrictions, security and the borrowers' cost cutting or revenue enhancement opportunities. In accordance with established practice, these exposures are carefully monitored individually and collectively to avoid concentrations and to identify incipient risks. The Group has been cautious in its commitments to these transactions and is satisfied with the results to date.

Lendings in offices in the United Kingdom

Lendings from UK offices now represent about three quarters of the Group's total lending book, with the main source of corporate and personal lending in the United Kingdom being the UK domestic bank's extensive branch network. The Mercantile Group also provides consumer and business finance services through its own branches.

The rate of growth in domestic lendings has been reduced across all categories in 1989 as a result of a general slow-down in the UK economy.

The slow-down has been particularly noticeable in the home mortgage market where growth was only 4% in 1989. This contrasts with rapid growth in the previous two years when the Bank took advantage of strong demand for home mortgage finance in the United Kingdom to become the largest bank lender in this market. Mortgages now represent 14% of UK lendings and 10% of Group lendings. They typically do not exceed 80% of the value of the property (as estimated at the time when the loan is made) and are predominantly at floating interest rates.

A major area of lendings growth was in the service industry sector which now represents 2[illegible]% of UK lendings. The increases in lendings to this sector over the last few years reflect the strong growth in service industries experienced in the United Kingdom. The lendings are well spread over a variety of businesses including retail and wholesale distribution, leisure, transport and communication industries.

The rate of growth in property and construction lending has slowed in recent months reflecting the impact of prevailing high interest rates on these sectors and on the economy as a whole.

The rise in the level of reported lendings to overseas customers from offices in the United Kingdom stemmed largely from the strengthening of the dollar against sterling during 1989. (See "Exposures to countries experiencing liquidity problems".)

Lendings in offices in the United States

Approximately half of the 27% growth in pounds sterling terms in US lendings in 1989 arose from the strengthening of the dollar against sterling. In dollar terms, the 13% growth in 1989 compared with a 10% increase in 1988, after adjusting for the disposal of Barclays Bank of California which occurred in that year. The principal area of growth in 1989 was in the Bank's US branches which increased lendings by 16% (1988 3%) mainly in the corporate sector.

Lendings in offices in the Rest of the World

Lendings in offices in the Rest of the World made up 14% of Group lendings at the end of 1989, having grown 33% in the year, following a 16% growth in 1988. The lending is well spread with the largest concentration, in France, accounting for 2.5% of Group lendings at the end of 1989. The areas of most rapid growth in 1989 were corporate lending in France, and personal lending in Spain, where the Group is expanding its branch network.

PLACINGS WITH BANKS AND CERTIFICATES OF DEPOSIT

The following table analyses placings with banks, based on the office from which the placing is made. Placings with banks repayable within 30 days are included in money at call and short notice in the financial statements.

	December 31		
	1989	1988	1987
		(£ million)	
Placings with banks, repayable beyond 30 days			
Offices in the United Kingdom	7,573	5,162	5,554
Offices outside the United Kingdom			
United States	1,176	1,611	1,755
Rest of the World	3,371	2,517	2,469
	12,120	9,290	9,778
Placings with banks, repayable within 30 days	8,825	7,313	7,860
	20,945	16,603	17,638

Barclays also held certificates of deposit at December 31, 1989 of £2,488 million (1988 £2,782 million, 1987 £1,[illegible] million). These are issued by financial institutions, have original maturities between 90 days and 5 years and are freely negotiable.

Barclays is an active participant in the major inter-bank markets. At December 31, 1989, placings and certificates of deposit with branches and offices of Japanese banks represented some 28% of the Group total.

ALLOWANCE FOR LENDING LOSSES

Provisioning policy

Lending managers continually review the quality of lendings for which they are responsible and, after assessment of all relevant information about each lending, a decision is made on whether a specific allowance should be raised.

Barclays policy is to raise, through provisions charged against income, specific allowances to cover the estimated loss of principal and interest as soon as the recovery of lendings is identified as doubtful. In addition, general allowances are maintained to cover losses which, although not specifically identified, are believed to be present in the lending portfolios, based on current knowledge of general economic conditions and past experience. Lendings are charged off in part or in whole when the extent of the loss incurred has been identified, the decision to do so being a matter of banking judgement.

Management believes that there are differences between the provisioning policies generally adopted in the United Kingdom and the United States. Barclays has normally continued to accrue interest in arrears, to add this overdue interest to the loan balance and to raise appropriate provision against it where recovery is doubtful. Loans and related accrued interest are charged off when, as a matter of banking judgement, the extent of the loss is identified. In contrast, banks in the United States typically stop accruing interest when loans become overdue by 90 days or more, or recovery is doubtful, and charge off loans more rapidly. The cumulative effect of these policies is to increase the relative size of Barclays gross loan portfolio and the allowance for lending losses, and so increase Barclays provisioning ratios, compared with those which could result from the adoption of US bank accounting practices.

Presentation of allowance for lending losses

The following tables have been divided between those allowances which have been made, in the normal course of business, against the perceived credit risks associated with the lending portfolio, and those allowances which have been made in respect of country risk (i.e. that related to a country's difficulty in servicing its external debt, as evidenced by rescheduling or arrears of interest or principal payments).

Previously, the country risk category only included allowances in respect of the principal amount of lendings, with allowances raised against outstanding interest being included in the credit risk category. The latter have now been transferred to the country risk category because of their increasing significance and the comparative figures have been restated accordingly.

Analysis of allowance for lending losses at year end

	Year ended December 31				
	1989	1988	1987	1986	1985
	(£ million)				
Allowance for credit risk					
Specific allowance					
United Kingdom	304	230	282	369	362
United Kingdom - overseas customers	19	14	23	28	9
United States	159	154	121	188	194
Rest of the World	219	187	242	287	302
	701	585	668	872	867
General allowance	218	175	262	242	372
	919	760	930	1,114	1,239
Specific allowance for country risk					
United Kingdom - overseas customers	1,580	895	855	209	13
	2,499	1,655	1,785	1,323	1,252

Movements in the allowance for lending losses

	Year ended December 31				
	1989	1988	1987 (£ million)	1986	1985
Allowance for credit risk (excluding allowance for country risk)					
Allowance at beginning of year	760	930	1 114	1 239	1 279
Recoveries					
United Kingdom	38	19	18	13	9
United Kingdom - overseas customers	1	-	-	1	-
United States	10	6	13	17	[illegible]
Rest of the World	4	2	3	1	[illegible]
	53	27	34	32	[illegible]
Amounts charged off					
United Kingdom	(155)	(196)	(250)	(193)	(166)
United Kingdom - overseas customers	(12)	(18)	(2)	(3)	(40)
United States	(27)	(88)	(107)	(107)	(74)
Rest of the World	(76)	(83)	(47)	(94)	(59)
	(370)	(385)	(406)	(397)	(349)
Provisions charged against income					
Specific provision					
United Kingdom	187	123	150	189	179
United Kingdom - overseas customers	9	4	3	22	11
United States	100	111	65	79	85
Rest of the World	88	39	52	54	88
	384	277	270	354	363
General provision	30	14	62	58	53
	414	291	332	412	416
Re-allocation of general allowance to specific allowance for country risk	-	(94)	(32)	(188)	-
Exchange and other adjustments	62	(9)	(112)	16	(127)
Allowance at end of year	919	760	930	1 114	1 239
Allowance for country risk					
United Kingdom - overseas customers					
Allowance at beginning of year	895	855	209	13	13
Provisions charged against income	983	10	740	4	-
Re-allocation from general allowance to specific allowance for country risk	-	94	32	188	-
Amounts charged off	(388)	(85)	-	-	-
Exchange and other adjustments	90	21	(126)	4	-
Allowance at end of year	1 580	895	855	209	13
Total allowance for lending losses	2 499	1 655	1 785	1 323	1 252

Analysis of amounts charged off

	Year ended December 31				
	1989	1988	1987	1986	1985
	(£ million)				
United Kingdom:					
Manufacturing	10	21	17	33	
Construction	5	7	9	10	90
Finance	-	1	1	2	
Service industries	27	47	45	55	
Agriculture, forestry and fishing	5	8	8	7	4
Property	2	4	5	6	4
Other businesses	1	-	2	1	3
Individuals	102	103	160	75	61
Finance lease receivables	3	5	3	3	4
	155	196	250	193	166
Foreign	603	274	156	204	183
	758	470	406	397	349

(1) Includes £388 million in 1989 (1988 £85 million) in respect of country risk.

Ratios

	Year ended December 31				
	1989	1988	1987	1986	1985
	%	%	%	%	%
Allowance at end of year as a percentage of lendings at end of year					
Allowance for credit risk					
Specific allowance	0.89	0.87	1.26	1.86	2.06
General allowance	0.27	0.26	0.49	0.52	0.88
	1.16	1.13	1.75	2.38	2.94
Specific allowance for country risk	2.00	1.33	1.61	0.44	0.03
	3.15	2.46	3.36	2.82	2.97
	(£ million)				
Average lendings for the year	74,140	59,776	49,685	44,296	41,967
	%	%	%	%	%
As a percentage of average lendings for the year:					
Provisions for credit risk					
Specific provisions	0.52	0.46	0.54	0.80	0.86
General provisions	0.04	0.02	0.13	0.13	0.13
	0.56	0.48	0.67	0.93	0.99
Specific provisions for country risk	1.32	0.02	1.49	0.01	-
	1.88	0.50	2.16	0.94	0.99
Amounts charged off (net of recoveries)	0.95	0.74	0.75	0.82	0.78

Review of provisions and allowance for lending losses

United Kingdom

Over the past five years, the United Kingdom has enjoyed a sustained period of economic growth during which Barclays lending has increased substantially over a broad spectrum of the corporate and personal sectors. During this period, Barclays has experienced no significant deterioration in the quality of its portfolio, as both corporate and individual borrowers have been able, on the whole, to service their debts on a timely basis. These facts are reflected in the low levels of charge-offs and Barclays provisioning experience as shown in the tables above. As interest rates increased during 1989 and the UK economic climate became less favourable, some indications emerged that economic difficulties were beginning to impact both the corporate and personal sectors and allowances rose from £230 million to £304 million. If the level of interest rates remains high, or increases during 1990, and economic conditions continue to deteriorate, additional provisioning may be necessary.

In 1987, substantial charge-offs against consumer credit lendings of the Mercantile Group contributed to the decline in the allowance.

United Kingdom - overseas customers

The major component of the increased provision for lending losses in 1989 was a charge against country risk of £983 million. A similar charge of £740 million was made in 1987. (See "Exposures to countries experiencing liquidity problems".)

United States

The overall provision for the US operations in 1989 was 10% lower than in 1988 when major provisions were charged in BarclaysAmericanCorporation ("BAC") against types of lending which have since been discontinued. Although provisions in BAC were lower in 1989, this was partially offset by increased provisions in the Banking Division. The higher charge-offs in 1989, following the increased provisions in 1988, resulted in a similar level of overall year-end allowance.

Rest of the World

Allowances against loan losses in the Rest of the World, which had fallen between 1985 and 1988, increased in 1989, mainly as a result of substantial provisions in Australia where high interest rates have caused particular problems for the corporate sector. The New Zealand operations made significant provisions for the second year in succession; this year the deterioration in the value of commercial property was the main cause while in 1988 the provisions resulted from the stock market decline. In Europe, higher provisions were recorded in Germany, France and Spain.

General allowance

The level of the general allowance has been increased in 1989 as a prudent response to the higher levels of specific allowances and increased lendings.

CROSS-BORDER OUTSTANDINGS

The world-wide operations of the Barclays Group give rise to significant exposures in non-local currencies. These cross-border outstandings are controlled through a well developed system of country limits, which are frequently reviewed to avoid concentrations of transfer, economic or political risks.

Cross-border outstandings, which exclude finance provided within the Group, are based on the country of domicile of the borrower or guarantor of ultimate risk and comprise lendings and finance lease receivables, placings with banks, interest bearing investments, acceptances and other monetary assets denominated in currencies other than the borrower's local currency.

At December 31, 1989, countries where Barclays cross-border outstandings exceeded 1% of assets were limited to Japan and France, and consisted substantially of placings with banks due within one year. In this context assets comprise total assets as presented in the consolidated balance sheet and acceptances, which together were £130,280 million at December 31, 1989 (1988 £107,514 million; 1987 £90,109 million).

Comparison between years is affected by the 12% strengthening of the dollar against sterling during 1989, and the 4% strengthening in 1988.

Cross-border outstandings exceeding 1% of assets

	As % of assets	Total	Banks and other financial institutions	Governments and official institutions	Commercial, industrial and other private sector
	%		(£ million)		
December 31, 1989					
Japan	3.9	5,068	4,947	61	60
France	1.7	2,237	2,071	107	59
December 31, 1988					
Japan	4.1	4,444	4,419	-	25
France	1.3	1,394	1,249	107	38
United States	1.1	1,148	746	5	397
December 31, 1987					
Japan	3.9	3,470	3,455	-	15
France	1.8	1,635	1,446	116	73
United States	1.0	918	609	5	304

Cross-border outstandings between ¾% and 1% of assets

Cross-border outstandings at December 31, 1989, due from countries where such outstandings individually represented between ¾% and 1% of assets, amounted in aggregate to £2,101 million (1988 £1,787 million; 1987 £3,118 million). The countries concerned were Italy and Switzerland at December 31, 1989; The Netherlands and Italy at December 31, 1988; and Switzerland, The Netherlands, Italy and Canada at December 31, 1987.

EXPOSURES TO COUNTRIES EXPERIENCING LIQUIDITY PROBLEMS

Barclays exposure to country risk has been substantially reduced during 1989, as illustrated in the table below

	Developing countries		Developed countries	
	December 31		December 31	
	1989	1988	1989	1988
	(£ million)			
Country risk exposure	1,748	1,968	735	700
Country risk allowance	(1,228)	(781)	(305)	(85)
Country risk exposure, net of allowance	520	1,187	430	615
Allowance as a % of exposure	70%	40%	41%	12%
Net exposure as a % of assets	0.4%	1.1%	0.3%	0.6%
Net exposure as a % of Ordinary shareholders equity	8.3%	20.8%	6.9%	10.8%

Notes:

Excluding those trade debts that are current and not affected by restrictions on payment, which are not material in amount.

In addition, an allowance of £47 million (1988 £29 million) was held in respect of the Group's share of similar lendings by other companies in which the Group has an interest.

Country risk exposure

During 1989, the impact of a 12% strengthening of the dollar against sterling, which had the effect of increasing the Group's country risk exposure as expressed in sterling, has been more than offset by loan sales with a face value of £482 million. In 1988, loan sales of £166 million were completed. Loan swaps of £412 million were also concluded during 1989 (1988 £234 million).

The largest exposures to developing countries at December 31, 1989, before taking account of allowances, were to Mexico (£571 million), Argentina (£309 million), Brazil (£281 million) and Venezuela (£198 million). The largest developed country exposure was to South Africa (£557 million) which continues to be repaid in accordance with that country's phased debt repayment arrangements.

Barclays is participating in the Mexican rescheduling package which was signed on February 7, 1990. Election was made to exchange £426 million of outstanding debt, 60% for a 30 year bond paying interest at a fixed rate of 6 1/4%, and 40%, at a 35% discount, for a 30 year bond paying interest at 13/16% over LIBOR. The principal amount of both types of bond will be secured by US Treasury zero coupon obligations and interest will be secured for a minimum period of 15 months and a maximum period of 18 months.

Country risk allowances

In 1987, when the banking industry reappraised the country risk problem, provisions of £740 million were raised. Allowances were strengthened in 1988 by a re-allocation from the general allowance of £94 million and by a small provision for outstanding interest.

In 1989 further provisions of £904 million were made following a deterioration in the economic and political condition and debt service performance of the debtor countries. This, together with a £79 million loss on loan sales in excess of existing allowances, resulted in a total charge of £983 million. Of the country risk allowances charged off, £308 million was related to sales of debt, including the loss over and above existing allowances, and £20 million arose from swaps.

US presentation

US accounting practica would be to record loans which have been acquired in a swap transaction at fair value at the date of acquisition, which would have the effect of significantly reducing country risk exposure and related allowances reported, but would not have a significant effect upon the net exposure.

POTENTIAL CREDIT RISK ELEMENTS IN LENDINGS

The Securities and Exchange Commission ("SEC") requires potential credit risk elements in lendings to be analysed by categories reflecting US lending and accounting practices which differ from those employed in the United Kingdom.

Two differences, which result in Barclays reporting amounts which would not necessarily be included by US banks, are -

1) In accordance with common UK bank accounting practice, Barclays generally does not charge off problem lendings as quickly as US banks do. As a result, Barclays reports a higher level of lendings than if it had followed US practice and this, in turn, gives rise to a correspondingly higher level of potential credit risk elements in lendings.

2) In contrast to US banks, Barclays normally continues to accrue interest in arrears, to add this overdue interest to the loan balance, and to raise an appropriate specific provision against it. While this does not affect net income in comparison with US practice, it again has the effect of increasing the reported level of potential credit risk elements in lendings which, in 1989, includes substantial interest outstanding from countries experiencing liquidity problems.

The following table presents the potential credit risk elements in lendings at December 31, 1989, 1988, 1987 and 1986 in accordance with SEC guidelines. An additional category of disclosure is, however, included to record lendings where interest continues to be accrued and specific provisions have been raised against interest or principal, where normal US banking practice would be to place such lendings on non-accrual status. Information for 1985 is not comparable with that presented for subsequent years, as it was not then possible to accumulate information on the current basis. For 1985, only lendings in offices in the United Kingdom and United States were reviewed and overdrafts were excluded from the analysis.

Amounts are stated before deduction of the value of security held and specific allowances provided against lendings.

		December 31				
		1989	1988	1987 (£ million)	1986	1985
Non-accrual lendings	United Kingdom	282	216	238	249	64
	Foreign - credit risk	368	249	250	243	66
Accruing lendings against which provisions have been made	United Kingdom	293	199	282	438	302*
	Foreign - credit risk	284	154	249	433	212*
	- country risk	544	654	358	34	39*
Accruing lendings 90 days overdue, against which no provisions have been made	United Kingdom	120	56	62	83	
	Foreign - credit risk	57	35	48	73	
Reduced rate lendings	United Kingdom	12	5	6	2	9
	Foreign - credit risk	24	35	16	15	7

* Accruing lendings 90 days overdue including those against which no provision has been made.

Lendings which are current as to payment of principal and interest and are not included in the above table, but where there exist serious doubts as to the ability of the borrower to comply with repayment terms in the near future, totalled approximately £153 million at December 31, 1989.

At December 31, 1989, Barclays exposure to borrowers in countries experiencing liquidity problems was £2,483 million. This total, against which allowances of £1,533 million are carried, includes the majority of short-term debts, but excludes those trade debts that are current and not affected by restrictions on payment in accordance with US reporting practice; the majority of this exposure is not reported within the above categories of potential credit risk. Lendings which are reported in the above table for 1989 include £305 million for Argentina (1988 £302 million), £179 million for Brazil (1988 £238 million), and £26 million for Ecuador (1988 £25 million).

In the year ended December 31, 1989, interest income of £246 million would have been recognised under the original terms of "non-accrual lendings", "accruing lendings against which provisions have been made" and "reduced rate lendings", but only £79 million was actually included in net income. Of the interest foregone of £167 million, £51 million related to UK customers and £116 million to foreign customers.

DEPOSITS

The following table analyses average deposits based on the location of the office in which the deposits are recorded

	Average Year ended December 31 1989	 1988	 1987
		(£ million)	
Offices in the United Kingdom	70,459	57,235	47,031
Offices outside the United Kingdom:			
United States	8,508	7,289	7,389
Rest of the World	17,918	13,528	12,405
	96,885	78,052	67,325

The following table analyses average deposits by type

		Average Year ended December 31 1989	 1988	 1987
			(£ million)	
Offices in the United Kingdom:				
Demand deposits	- interest free	7,032	7,462	7,012
	- interest bearing	2,436	1,218	904
Savings deposits		15,326	11,437	9,471
Other time deposits	- Retail	10,943	8,037	7,160
	- Wholesale	34,722	29,081	22,484
		70,459	57,235	47,031
Offices outside the United Kingdom:				
Demand deposits	- interest free	1,424	1,458	1,696
	- interest bearing	1,370	591	617
Savings deposits		1,113	917	950
Other time deposits	- Government and official institutions	383	395	420
	- Banks	9,406	7,946	7,422
	- Other	12,730	9,510	9,189
		96,885	78,052	67,325

"Demand deposits" in offices in the United Kingdom are mainly current accounts with credit balances, obtained through the Bank's branch network. Most of these are interest free. However, the proportion that bears interest is increasing, following the introduction of a new current account package for personal customers in 1989.

"Savings deposits" in offices in the United Kingdom are also obtained through, and administered by, the Bank's domestic network. Interest rates are varied from time to time in relation to competitive conditions. These deposits are not drawn against by cheque or similar instrument.

"Other time deposits - Retail" in offices in the United Kingdom are interest bearing and are not drawn against by cheque or similar instrument. They are generally distinguished from savings deposits by having fixed maturity requirements and from wholesale deposits by being collected, in the main, through the Bank's branch network.

"Other time deposits - Wholesale" in offices in the United Kingdom are obtained through the London money market and are booked mainly within the Bank's treasury operations. These deposits are of fixed maturity and bear interest rates which reflect London inter-bank money market rates.

"Other time deposits" includes commercial paper and inter-bank funds.

Commercial paper

Commercial paper is issued by the Group mainly in the United States. It is generally issued in denominations of not less than $100,000, with maturities of up to 270 days.

	Year ended December 31		
	1989	**1988**	**1987**
		(£ million)	
Year-end balance	3,221	2,125	1,829
Average balance	2,839	1,993	1,875
Maximum balance	3,221	2,358	1,914
Average interest rate during year	9.5%	7.8%	6.8%
Year-end interest rate	8.9%	9.2%	7.7%

Inter-bank funds

In addition to issuing commercial paper, US banks also fund their short-term liquidity needs through overnight and term federal funds, repurchase agreements and other short-term borrowings. In contrast, Barclays, like other UK banks, obtains additional short-term funds through inter-bank money markets both in the United Kingdom and overseas.

	Year ended December 31		
	1989	**1988**	**1987**
		(£ million)	
Year-end balance	22,841	22,363	20,272
Average balance	23,921	21,398	17,896
Maximum balance	26,824	22,672	20,272

ASSET/LIABILITY MANAGEMENT

Barclays manages its range of instruments and products, which may involve interest rate or exchange rate exposure, by imposing controls in terms of the size of local and global holdings of each instrument. Head Office sets and monitors exposure limits for all domestic and overseas operations, consistent with the size and nature of each operation, and ensures the maintenance of standards through regular reporting systems and visits by senior management, internal audit and treasury supervision teams. Given the large number of countries in which Barclays operates and the different currencies of these countries, day-to-day asset/liability management is generally decentralised within the framework of Head Office control. Asset/liability management policy is overseen by a committee of the Board which is chaired by the Managing Director.

Liquidity

The management of liquidity in a major international banking group such as Barclays is primarily directed towards ensuring that local funding requirements can be met, both to replace existing funds, as they mature or are withdrawn, and to satisfy the demands of customers for additional borrowings.

To ensure access to funds, the distribution of sources and maturities of deposits is actively managed in order to avoid a concentration of funding requirements at any one time and from any one source. Important factors in assuring liquidity are competitive rates and the maintenance of depositors' confidence. Such confidence is based on reputation, the strength of earnings and the soundness of the balance sheet.

A substantial portion of Barclays assets in the United Kingdom, and in certain other retail banking areas, is funded with "core deposits". These important sources of liquidity are mainly current accounts and savings deposits. Although current accounts are repayable on demand, and savings accounts are repayable on short notice, the spread by number and type of depositor helps to insure against unexpected fluctuations and such accounts form a stable deposit base for Barclays operations.

At the end of 1989, about one fifth of Barclays total deposits was raised through the eurocurrency markets. Eurocurrencies are currencies owned and freely traded outside the country in which they are legal tender and consist principally of dollars. Eurocurrency deposits are principally time deposits and are raised primarily from other banks, corporate customers, quasi-governmental institutions, central banks and governments. At December 31, 1989, approximately 55% of the funds derived from these deposits was placed with other banks while the remaining funds were lent at fixed maturities to corporate, sovereign and other borrowers. Of these loans, over 60% was lent short-term (less than one year) and the remainder medium-term. As is the case with the lending portfolio overall, these placings and loans are subject to continual review and limits are placed on the exposure to each borrower and within each country.

Liquidity management also involves control over asset maturities and the volume and quality of holdings of cash and short-term funds. In addition, in evaluating its liquidity position, management has regard to undrawn loan commitments, the usage of overdraft facilities and the possible impact of certain outstanding contingent liabilities, such as standbys.

The responsibility for liquidity rests with local management at each location, subject to control by and regular reporting to Head Office. In territories with treasury operations, the strategic control of liquidity and balance sheet management is vested in a local Asset and Liability Committee comprised of senior managers. Reporting takes the form of a cashflow measurement of liquidity based on principles outlined by the Bank of England. Each operation is required to maintain sufficient access to liquid funds, in terms of maturing assets and proven capacity to borrow in the money markets, to ensure that maturing liabilities can be repaid and commitments to lend honoured. Special attention is paid to projections of cashflow within the next week and the next month and a sufficient reserve of marketable assets is maintained to protect against unforeseen cash flow volatility. The positions are scrutinised to prevent future problems, with particular emphasis being placed on the need to monitor unmatched medium-term loans, which, if excessive, may contribute to liquidity problems in the future.

Interest rate and exchange rate exposure

Barclays policy is to limit the adverse profit impact of interest rate and exchange rate changes, while taking advantage of opportunities to increase profits by taking mismatched positions.

In general, interest rate risk is measured for each operation by constructing mismatch ladders in which assets and liabilities in each currency are classified into maturity bands according to their next re-pricing date. Other complementary techniques, such as simulation and duration analysis, are also used where the ladder approach is thought to be insufficient. A similar technique is applied to measure the exposure arising from movements in the margins on unmatched forward foreign exchange transactions. Each operation also monitors its net bought/sold position in each currency, with an overall limit set by Head Office as a sub-limit to the currency exposure ceiling agreed with the Bank of England.

The interest rate risk attached to the positions of retail operations is also assessed and monitored in Head Office. Particular attention is paid to the sterling element of the balance sheet, which accounted for over half of the Group's assets at December 31, 1989. In common with other UK clearing banks, there is a substantial volume of liabilities which do not bear interest. This creates a favourable effect when interest rates rise on floating rate assets and an unfavourable effect when interest rates fall. The effect, which is reducing as a proportion of income, is managed by the maintenance of a portfolio of assets with interest rates fixed for several years, particularly loans to customers, government bonds and interest rate swaps. Care is taken to ensure that hedging is not too inflexible, as market circumstances could rapidly change the desirable portfolio structure. In January 1989, Barclays announced the introduction of a new current account package for personal customers, which has resulted in interest being paid on a larger proportion of these balances.

Dealing operations are required to operate at all times within limits determined by Head Office. These limits take into account the depth of the local market, the experience of the local dealing team, the demands of the type of business and Barclays total capacity to accept risk. Dealing positions are reported frequently to Head Office, with foreign exchange positions being reported daily.

Management of the funding of investments in overseas branches, subsidiaries and associates is located in Head Office, where the operation of the funding policy is regularly reviewed.

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

Year ended December 31 (Amounts in £ million)

	1989			1988			1987		
ASSETS	Average Balance	Interest	Average Rate %	Average Balance	Interest	Average Rate %	Average Balance	Interest	Average Rate %
Short-term funds (ii)									
in offices in the UK	11 985	1 148	9.6	9 411	716	7.6	8 055	548	6.8
in offices outside the UK	5 929	568	9.6	4 344	327	7.5	4 193	303	7.2
	17 914	1 716	9.6	13 755	1 043	7.6	12 248	851	6.9
Securities									
in offices in the UK	858	83	9.7	1 378	132	9.6	1 238	137	11.1
in offices outside the UK	986	88	8.9	985	85	8.6	1 068	94	8.8
	1 844	171	9.3	2 363	217	9.2	2 306	231	10.0
Placings with banks over 30 days									
in offices in the UK	6 512	749	11.5	5 278	497	9.4	5 355	450	8.4
in offices outside the UK	5 088	543	10.7	4 430	338	7.6	4 056	290	7.1
	11 600	1 292	11.1	9 708	835	8.6	9 411	740	7.9
Lendings to customers									
in offices in the UK	51 876	7 607	14.7	41 253	5 106	12.4	32 035	3 957	12.4
in offices outside the UK	17 719	2 066	11.7	14 479	1 505	10.4	14 327	1 455	10.2
	69 595	9 673	13.9	55 732	6 611	11.9	46 362	5 412	11.7
Lease receivables									
in offices in the UK	3 791	512	13.5	3 408	358	10.5	2 829	324	11.5
in offices outside the UK	754	104	13.8	636	83	13.1	494	75	15.2
	4 545	616	13.6	4 044	441	10.9	3 323	399	12.0
Total average interest earning assets									
in offices in the UK	75 022	10 099	13.5	60 728	6 809	11.2	49 512	5 416	10.9
in offices outside the UK	30 476	3 369	11.1	24 874	2 338	9.4	24 138	2 217	9.2
	105 498	13 468	12.8	85 602	9 147	10.7	73 650	7 633	10.4
Allowance for loan losses	(1 794)			(1 756)			(1 534)		
Securities trading assets	6 836			3 991			3 516		
Accrued interest and other accounts	4 021			2 971			3 031		
Cash, balances with central banks and items in course of collection	1 614			1 635			1 693		
Investments in associated companies and trade investments	364			303			273		
Property and equipment	1 947			1 729			1 518		
Total average assets and interest income	118 486	13 468	11.4	94 475	9 147	9.7	82 147	7 633	9.3
Percentage of total average assets applicable to offices outside the UK	27%			28%			31%		

Notes

(i) Lendings to customers include all doubtful lendings, including non-accrual loans. Interest income on such lendings has been included to the extent to which either cash payments have been received, or interest has been accrued in accordance with the income recognition policy of the Group.

(ii) Placings with banks repayable within 30 days (included within short-term funds)

	1989	1988	1987
		(£ million)	
in offices in the UK	4 909	4 428	4 009
in offices outside the UK	4 280	3 257	3 101
	9 189	7 685	7 110

Year ended December 31 (Amounts in £ million)

LIABILITIES AND SHAREHOLDERS' EQUITY	1989 Average Balance	1989 Interest	1989 Average Rate %	1988 Average Balance	1988 Interest	1988 Average Rate %	1987 Average Balance	1987 Interest	1987 Average Rate %
Demand deposits									
In offices in the UK	2 436	194	8 0	1 218	117	9 5	904	70	7 7
In offices outside the UK	1 370	108	7 9	591	28	4 7	617	32	5 2
	3 806	302	7 9	1 809	145	8 0	1 521	102	6 7
Savings deposits									
In offices in the UK	15 326	1 723	11 2	11 437	902	7 9	9 471	723	7 6
In offices outside the UK	1 113	75	6 7	917	52	5 7	950	53	5 6
	16 439	1 798	10 9	12 354	954	7 7	10 421	776	7 4
Other time deposits - retail									
In offices in the UK	10 943	1 287	11 8	8 038	690	8 6	7 159	608	8 5
In offices outside the UK	3 711	389	10 5	2 673	224	8 4	2 518	204	8 1
	14 654	1 676	11 4	10 711	914	8 5	9 677	812	8 4
Other time deposits - wholesale									
In offices in the UK	34 722	4 101	11 8	29 080	2 666	9 2	22 485	1 921	8 5
In offices outside the UK	18 808	1 801	9 6	15 178	1 182	7 8	14 513	1 078	7 4
	53 530	5 902	11 0	44 258	3 848	8 7	36 998	2 999	8 1
Long-term borrowings									
In offices outside the UK	894	84	9 4	790	78	9 9	830	83	10 0
Long-term debt and undated capital notes									
Principally in offices in the UK	2 593	286	10 6	2 548	242	9 5	2 347	190	8 1
Total average interest bearing funds									
In offices in the UK	66 120	7 591	11 5	52 321	4 617	8 8	42 366	3 512	8 3
In offices outside the UK	25 896	2 457	9 5	20 149	1 564	7 8	19 428	1 450	7 5
	92 016	10 048	10 9	72 470	6 181	8 5	61 794	4 962	8 0
Interest free demand deposits									
In offices in the UK	7 032			7 462			7 012		
In offices outside the UK	1 424			1 458			1 696		
	8 456			8 920			8 708		
Securities trading liabilities	6 354			3 642			3 315		
Other liabilities	5 261			4 286			4 287		
Shareholders' equity and minority interests	6 399			5 157			4 043		
Total average liabilities and shareholders' equity and interest expense	118 486	10 048	8 5	94 475	6 181	6 5	82 147	4 962	6 0
Percentage of total average non-capital liabilities applicable to offices outside the UK	26%			25%			28%		
Total average interest earning assets	105 498			85 602			73 650		
Related to									
Interest income		13 468	12 8		9 147	10 7		7 633	10 4
Interest expense		10 048	9 6		6 181	7 2		4 962	6 8
Net interest income		3 420	3 2		2 966	3 5		2 671	3 6

Average balances are based upon weekly averages for certain areas of UK banking operations and monthly averages elsewhere which Barclays considers are representative of its operations

CHANGES IN NET INTEREST INCOME - VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between changes in volume and changes in rate for the latest two years Volume and rate variances have been calculated on the movement in the average balances and the change in the interest rates on average interest earning assets and average interest bearing liabilities The variance caused by changes in both volume and rate has been allocated to volume

	1989/1988			1988/1987		
	Total Change	Change due to increase/decrease in Volume	Rate	Total Change	Change due to increase/decrease in Volume	Rate
			(£ million)			
Interest income						
Short-term funds						
in offices in the UK	432	244	188	168	104	54
in offices outside the UK	241	150	91	24	11	13
	673	398	275	192	108	66
Securities						
in offices in the UK	(49)	(50)	1	(5)	14	(19)
in offices outside the UK	3	-	3	(9)	(7)	(2)
	(46)	(48)	2	(14)	4	(18)
Placings with banks over 30 days						
in offices in the UK	252	141	111	47	(7)	54
in offices outside the UK	205	68	137	48	28	20
	457	214	243	95	29	66
Lendings to customers						
in offices in the UK	2 501	1 552	949	1 149	1 149	-
in offices outside the UK	561	373	188	50	21	29
	3 062	1 947	1 115	1 199	1 106	93
Lease receivables						
in offices in the UK	154	52	102	34	62	(28)
in offices outside the UK	21	17	4	8	18	(10)
	175	66	109	42	79	(37)
Total interest income						
in offices in the UK	3 290	1 893	1 397	1 393	1 244	149
in offices outside the UK	1 031	608	423	121	73	48
	4 321	2 523	1 798	1 514	1 293	221
Interest expense						
Demand deposits						
in offices in the UK	77	96	(19)	47	30	17
in offices outside the UK	80	61	19	(4)	(1)	(3)
	157	159	(2)	43	23	20
Savings deposits						
in offices in the UK	821	444	377	179	151	28
in offices outside the UK	23	14	9	(1)	(2)	1
	844	449	395	178	147	31
Other time deposits retail						
in offices in the UK	597	340	257	82	75	7
in offices outside the UK	165	109	56	20	12	8
	762	451	311	102	92	10
Other time deposits wholesale						
in offices in the UK	1 435	679	756	745	588	157
in offices outside the UK	619	346	273	104	46	58
	2 054	1 036	1 018	849	627	222
Long-term borrowings						
in offices outside the UK	6	10	(4)	(5)	(4)	(1)
Long-term debt and undated capital notes						
Principally in offices in the UK	44	16	28	52	19	33
Total interest expense						
in offices in the UK	2 974	1 561	1 413	1 105	893	212
in offices outside the UK	893	550	343	114	56	58
	3 867	2 128	1 739	1 219	910	309
Net interest income	454	395	59	295	383	(88)

SUPERVISION AND REGULATION

In common with their counterparts in the United States and Japan, banks in the United Kingdom are supervised on a functional, rather than an institutional basis but do not face the statutory impediments to transacting securities business inherent in the US and Japanese regulatory systems. Thus, a bank may directly undertake a wider range of business in the United Kingdom than in the United States or Japan but, as a result, will find it necessary to meet the requirements of a number of regulators.

Banking business in the United Kingdom has been supervised by the Bank of England for many years under the authority of various statutes (the "banking acts"). The latest and most important of these is the Banking Act 1987, which further strengthened supervision in a number of areas.

The main provisions of the banking acts include a requirement for deposit-taking businesses to be licensed by the Bank of England, detailed criteria for the authorisation of banking institutions and a requirement to report large exposures. They also define the roles in the supervisory framework for a Board of Banking Supervision and for auditors. The former advises the Bank of England on the exercise of its supervisory duties and the latter are empowered to provide the Bank of England with independent confirmation of the adequacy of accounting and other records, systems of control and the accuracy of supervisory information. The banking acts also provide for the control of bank names, descriptions and advertisements and the establishment of a deposit protection scheme. Under the scheme, which is similar to the US Federal Deposit Insurance Corporation system, depositors with a failed institution will receive 75% of their deposits from a fund, subject to a limit of £20 000 in respect of a protected deposit.

In the performance of its obligations under the banking acts, the Bank of England has developed a number of formal codes in consultation with the banks. These relate, inter alia, to capital adequacy (see "Capital Resources"), liquidity and foreign currency exposures, large exposures, the adequacy of accouting and other records and control systems, loan transfers and securitisation, advertising and the Bank of England's relationship with auditors of banks. Further codes are in the course of development.

The Bank of England's approach to supervision involves a good understanding by senior staff in its Banking Supervision Division of the business of the banks for whose supervision they are responsible and of the key business risk areas involved. This understanding is made possible by the filing of regular and ad-hoc reports, frequent consultations between the Bank of England and senior management of the banks and visits by supervisory staff to operating areas of the banks. The regular reports include operating statements, information concerning operational practices and organisational changes, periodic prudential returns of capital adequacy, liquidity, lendings analysed by industry sector and geographical area and other analyses of sterling and currency assets and deposits.

The eurocurrency activities of all banks operating in the United Kingdom are closely monitored by the Bank of England although, because of the international character of the eurocurrency market, there exists no overall regulatory authority governing its activities. Barclays eurocurrency transactions are booked mostly in London, the world's leading eurocurrency centre.

Securities business and other financial services are supervised within a framework established under the authority of the Financial Services Act 1986 (the "1986 Act"). The regulatory powers vested in the Secretary of State for Trade and Industry under the 1986 Act have been delegated to the Securities and Investments Board ("SIB"), a private sector body. The SIB has handed down certain powers to a number of Self Regulatory Organisations ("SROs") and recognised professional bodies, which authorise and supervise individual securities and investments businesses.

The burden of multiple regulation, arising from functional supervision, has been reduced, to a degree, by the existence of a number of "lead regulator" agreements between the Bank of England and various SROs, whereby the Bank of England acts as overall regulator for the banks' activities in the United Kingdom, including monitoring of compliance with the capital requirements of SROs for securities business.

Barclays UK securities trading business is conducted mainly through specialist subsidiary companies of BZW which are subject to supervision by the SROs of which they are members. The capital adequacy requirements of the SROs are more detailed than those of the Bank of England; in particular, they call for calculations of position risk, of which interest rate risk forms the major component, which must be submitted at frequent intervals.

Supervision and regulation (continued)

Current SRO "conduct of business" rules were developed to afford investors at least the same degree of protection as they would receive if securities business was regulated directly by the SIB ("the equivalence test"). The Companies Act 1989, however, contains amendments to the 1986 Act which empower the SIB to issue statements of principles, designate rules, and issue codes of practice, to be applied directly to SRO members. A number of designated rules have now been drafted mainly in an attempt to clarify existing conduct of business rules. The equivalence test, which had contributed to the complexity of SRO rulebooks, has now been replaced by a requirement for rules, which, together with the SIB's requirements, "afford an adequate level of protection for investors". These changes, and their potential effect on the independent regulatory role of the SROs, are currently the subject of debate within the UK financial services industry.

In the United States, Barclays PLC, Barclays Bank PLC and certain US subsidiary companies of the Bank are subject to the US Bank Holding Company Act of 1956, as amended, and Barclays PLC and Barclays Bank PLC are also subject to the US International Banking Act of 1978. These statutes impose limitations on the types of business conducted in the United States and on the location and expansion of banking business in the United States. The International Banking Act extended reserve requirements to all of Barclays banking operations in the United States.

In the Rest of the World, Barclays operates in 74 other countries and its overseas offices and subsidiary and associated companies are subject to reserve and reporting requirements and controls imposed by the central banks and other regulatory authorities in the majority of those countries. Within the European Community, the proposed creation of a single financial market by 1992 is already establishing a trend towards a harmonised institutionally based regulatory environment, with emphasis on the role of the home country regulator. While changes in regulatory requirements will inevitably result, Barclays expects to benefit in due course from the European regulators' adoption of common measures and standards.

MONETARY AND FISCAL POLICIES

The earnings of Barclays are affected by general domestic and overseas economic conditions and, in the United Kingdom, by the monetary and fiscal policies of the British Government and regulatory authorities. The Bank of England, the government-owned central bank, influences conditions in the money and credit markets, which affect interest rates, the growth in lendings, the distribution of lending between various industry sectors and the growth of deposits. In this connection, banks in the United Kingdom are required to maintain, in non-interest bearing accounts at the Bank of England, a non-operational cash balance of 0.45% of eligible liabilities, which are sterling deposits less amounts on loan to other monetary institutions.

Monetary and fiscal policies have had a significant effect on the operations and profitability of UK banks in the past and are expected to do so in the future. Similarly, the monetary and fiscal policies of governments in other countries where Barclays operates affect the operations and profitability of the Group in those countries. Barclays cannot accurately predict the effect such policies may have on lending volumes and earnings.

PROPERTIES

Barclays owns property used for its business in many countries. The principal executive office is located at 54 Lombard Street, London, England. Permission has been obtained to redevelop this site and it is expected that work will commence in 1990 and that the development costs will be approximately £100 million. During the four years that the development is expected to take to complete, many of the Bank's head office departments are being relocated to new offices at Royal Mint Court to the east of London's financial district.

A number of operations are also being relocated from central London to Coventry, where new premises are nearing completion. Mercantile Group has also relocated its head office to Basingstoke in order to avoid the high costs associated with operating within central London.

LEGAL PROCEEDINGS

Barclays is party to various legal proceedings arising in the ordinary course of business, the ultimate resolution of which is not expected to have a material adverse effect on consolidated net income or shareholders' equity.

In connection with an agreement in 1987 for the sale by British and Commonwealth Holdings PLC ("B&C") to Quadrex Holdings Inc. ("Quadrex") of the wholesale moneybroking businesses of Mercantile House Holdings PLC, B&C brought a legal action against Quadrex and another legal action against Samuel Montagu and Co. Limited ("SM"). In B&C's action against SM, Barclays de Zoete Wedd Limited ("BZW") was joined by SM in third party proceedings. Subsequently, in B&C's action against Quadrex, BZW was joined as a defendant to Quadrex's counterclaim against B&C. SM has also given notice that it intends to pursue a fourth party claim against BZW in that action. The claims against BZW have not been quantified and resolution of quantum has been deferred until after the conclusion of the trial on liability, which is expected to start at the end of April 1990. The claims against BZW will be vigorously defended.

In common with other banks, the Group has, in the normal course of business, entered into swap transactions with certain UK local authorities. The legality of such contracts has been challenged and on February 22, 1990 the Court of Appeal ruled that certain of the swap transactions entered into by one Local Authority were unlawful. Although, in the light of this ruling, the Group considers the preponderance of its swap transactions with local authorities to be lawful, it has been thought prudent to raise a full provision in respect of all outstanding swap transactions with local authorities until a complete appraisal of the implications of the ruling has been carried out. Such provision, which is included in other expenses, amounts to £37 million and is based on interest rates ruling at the year end.

CONTROL OF REGISTRANT

All of the outstanding Ordinary Shares of £1 each of Barclays Bank PLC are beneficially held by Barclays PLC.

No notification has been received that any one person, whether a Director or otherwise, has an interest in 5% or more of the Ordinary share capital of Barclays PLC.

MANAGEMENT

Directors at December 31, 1988

Name	Barclays PLC Position held since	Barclays PLC Director since	Barclays Bank PLC Position held since	Barclays Bank PLC Director since
Chairman				
Sir John Quinton	1987	1982	1987	1985
Deputy Chairmen				
Sir Martin Jacomb	1985	1985	1985	1985
Peter Evelyn Leslie	1987	1980	1987	1979
Vice-Chairman				
Andrew Robert Fowell Buxton	1985	1984	1985	1984
(Managing Director - since 1988)				
Directors				
David Band	1988	1988	1988	1988
(Chief Executive - BZW)				
Lord Camoys		1984		1979
Humphrey Thomas Norrington	1987	1985	1987	1985
(Executive Director, Overseas Operations)				
Brian Gerald Pearse	1987	1987	1987	1987
(Finance Director)				
Owen Howard Rout	1987	1987	1987	1987
(Executive Director, UK Operations)				
Anthony John de Nouaille Rudge		1972		1985
Kenneth Brian Sinclair		1988		1988
Alan George Tritton		1974		1985
Non-Executive Directors				
Dr David Valentine Atterton CBE		1984		1985
Mrs Mary Elizabeth Baker		1988		1988
Sir Timothy Bevan		1966		1971
Ian Geoffrey Butler		1985		1985
Sir Michael Franklin KCB, CMG		1988		1988
Sir Denys Henderson		1983		1981
Henry Uvedale Antrobus Lambert		1966		1974
Sir Nigel Mobbs DL		1979		1985
Sir James Spooner		1983		1985
Sir Charles Tidbury DL		1978		1985
Sir Anthony Tuke		1965		1966

Executive Officers at December 31, 1989

	Barclays PLC Position held since	Barclays Bank PLC Position held since
Senior Management		
Anthony Richard Paul Carden		1983
Mark Christopher Deverell		1989
The Hon. Seymour Henry Fortescue		1985
William John Gordon		1987
John Anthony Kerslake		1983
Geoffrey Ruscoe Miller		1986
Trevor Ian Nicholas		1985
Francis Alastair Lavie Robinson		1987
John Hayes Clayton Whicker		1989
Peter Anthony Wood		1987
Secretary		
John Michael David Atterbury	1983	1983
Chief Accountant		
Nicholas John Brittain	1986	1986

Changes in management subsequent to December 31, 1989

Mr J D Birkin was appointed as a Director of the Bank and of Barclays PLC with effect from January 1, 1990. The Rt. Hon. Nigel Lawson M.P. was appointed as a Director of the Bank and of Barclays PLC with effect from February 1, 1990. Mr O H Rout will retire as a Director and as Executive Director, UK Operations on April 15, 1990. On April 16, 1990, Mr F A L Robinson will join the Boards of the Bank and Barclays PLC and will be appointed Executive Director, UK Operations. Sir Anthony Tuke will retire as a Director on April 26, 1990.

Mr G D Cracknell will become an executive officer of the Bank on April 16, 1990.

Committees of Directors

The Chairman, Deputy Chairmen and Vice-Chairman form the Group Chair and together with certain other Executive Directors collectively perform group management functions similar to those of an executive committee of the board of directors of a US corporation.

The Audit Committee of Barclays PLC performs functions similar to those of an audit committee of a US corporation. The Audit Committee, consisting of Non-Executive Directors, at December 31, 1989 comprised Sir Nigel Mobbs (Chairman), Dr D V Atterton, Mr H U A Lambert, Sir James Spooner, Sir Charles Tidbury and Sir Anthony Tuke. With effect from January 1, 1990, Sir Anthony Tuke retired from the Committee and Mr I G Butler was appointed to the Committee.

The Finance Committee reviews the Group's financial statements, annual financial plans and other financial matters. In addition to the members of the Group Chair, the Finance Committee at December 31, 1989 comprised Mrs Mary Baker, Sir Timothy Bevan, Mr I G Butler, Sir Michael Franklin, Sir Denys Henderson, Mr H U A Lambert and Sir Nigel Mobbs. With effect from January 1, 1990, Mr I G Butler retired from the Committee and Mr J D Birkin was appointed to the Committee.

Terms of office of Directors

One fourth (or the nearest whole number below one fourth) of the Directors of Barclays PLC are required to retire by rotation at each Annual General Meeting ("AGM"), together with Directors newly appointed since the previous AGM in accordance with power given to the Board. The Directors retiring by rotation and the newly appointed Directors (who must retire at the AGM following their election) are eligible to stand for re-election.

Remuneration

The aggregate remuneration of all Directors and officers of Barclays PLC (28 persons) for the year ended December 31, 1989 amounted to £3 226 000 (including entitlements under profit sharing schemes (see note 5 to the financial statements)). The aggregate amount set aside by the Barclays PLC Group for the year ended December 31, 1989 to provide pension benefits for the Directors and officers amounted to £392 000.

The aggregate remuneration of all Directors and officers of Barclays Bank PLC (40 persons) for the year ended December 31, 1989 amounted to £4 518 000 (including entitlements under profit sharing schemes (see note 5 to the financial statements)). The aggregate amount set aside by the Bank and its subsidiary companies for the year ended December 31, 1989 to provide pension benefits for the Directors and officers amounted to £538 000.

As set forth in the Barclays PLC 1989 Report and Accounts, and the Barclays Bank PLC 1989 Report and Accounts, the emoluments of the Chairman payable by the Group in respect of the year ended December 31, 1989, computed for the purposes of disclosure under the UK Companies Act 1985, amounted to £332,920. The emoluments comprise salaries, fees and other items, including any such amounts payable by subsidiaries and other companies where the Chairman is nominated for such service in the interests of Barclays PLC. The emoluments of the highest paid Director, in respect of the year ended December 31, 1989, amounted to £470 283. One director waived the right to receive emoluments of £5,144.

Employment contracts

The Bank currently has service agreements with certain of its Executive Directors and executive officers. Each such agreement establishes a salary at a specific rate, or such larger sum as the Board may decide upon from time to time, and provides for a maximum term of five years, or until the sixtieth birthday of the individual involved.

Indebtedness and material transactions

Details of loans to, and arrangements and agreements with, Directors and connected persons and executive officers of Barclays PLC and Barclays Bank PLC, which require disclosure in accordance with relevant UK legislation applicable to banking groups, as at December 31, 1989, are:

	Number of persons	Amount (£ thousand)
Loans	29	1 263
Quasi-loans and credit card accounts	54	102
Total		1 365

There are no transactions, arrangements or agreements with Barclays PLC or its subsidiary companies in which Directors, or persons connected with them, or senior executives of Barclays Bank PLC had a material interest and which are disclosable under the relevant provisions of the UK Companies Act 1985, other than options to subscribe for Ordinary Shares under the Barclays PLC Executive and Save-as-you-Earn Share Option Schemes as separately shown below.

Share options

Directors and officers of Barclays PLC as a group (involving 25 persons) held, at December 31, 1989 options to purchase 1.315.697 Barclays PLC £1 Ordinary Shares at prices ranging from 220p to 453p under the Save-as-you-Earn Scheme and ranging from 403p to 514p under the Executive Scheme, exercisable in the period from 1990 to 1999.

The individual options held at December 31, 1989 by each Director were as follows:

	Save-as-you-Earn Scheme	Executive Scheme
D Band	-	148.800
A R F Buxton	1.775	135.643
Lord Camoys	2.875	121.022
Sir Martin Jacomb	2.875	145.857
P E Leslie	2.000	140.453
H T Norrington	1.849	111.228
B G Pearse	2.458	77.177
Sir John Quinton	-	227.157
O H Rout	-	87.628
A J de N Rudge	2.620	-

There were no significant changes in the above options up to February 1, 1990.

Share ownership

The beneficial ownership of the Ordinary share capital of Barclays PLC by all Directors and officers of Barclays PLC as a group (involving 25 persons), at December 31, 1989, amounted to 293.000 £1 Ordinary Shares (0.03% of Ordinary share capital outstanding).

CONSOLIDATED FINANCIAL STATEMENTS

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There are two sets of consolidated financial statements included in this Annual Report. The financial statements of Barclays PLC and its subsidiary companies are shown on pages 50 to 53 and the financial statements of Barclays Bank PLC and its subsidiary companies are shown on pages 54 to 57. The notes commencing on page 58 apply equally to both sets of financial statements unless stated otherwise.

REPORT OF INDEPENDENT AUDITORS

To the Boards of Directors and Shareholders of

BARCLAYS PLC
BARCLAYS BANK PLC

We have audited the consolidated financial statements of Barclays PLC and its subsidiary companies and Barclays Bank PLC and its subsidiary companies on pages 50 to 87 inclusive. These financial statements are the responsibility of the companies' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the consolidated financial statements audited by us present fairly, in all material respects, the financial position of Barclays PLC and its subsidiary companies and Barclays Bank PLC and its subsidiary companies at December 31, 1989 and 1988, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1989, in conformity with accounting principles generally accepted in the United Kingdom.

Accounting principles generally accepted in the United Kingdom vary in certain significant respects from accounting principles generally accepted in the United States. The application of the latter would have affected the determination of consolidated net income for each of the three years in the period ended December 31, 1989 and the determination of the consolidated shareholders' equity at December 31, 1989 and 1988 to the extent summarised in note 30 to the consolidated financial statements.

PRICE WATERHOUSE
Chartered Accountants

London, England
February 28, 1990

BARCLAYS PLC

CONSOLIDATED STATEMENT OF INCOME

Note		Year ended December 31 1989	 1988	 1987
			(£ million)	
2	Interest income	13,468	9,147	7,633
3	Interest expense	(10,048)	(6,181)	(4,962)
	Net interest income	3,420	2,966	2,671
4	Other operating income	2,127	1,785	1,550
		5,547	4,751	4,221
5	Operating expenses	(3,550)	(3,155)	(2,848)
		1,997	1,596	1,373
12	Provision for lending losses	(1,397)	(301)	(1,072)
		600	1,295	301
14	Share of income before taxes of associated companies	92	96	68
	INCOME BEFORE TAXES AND MINORITY INTERESTS	692	1,391	369
7	Applicable taxes	(215)	(498)	(159)
	Income before minority interests	477	893	210
	Minority interests	(25)	(6)	(6)
	NET INCOME	452	887	204
			(pence)	
8	NET INCOME PER £1 ORDINARY SHARE	40.4	87.8	24.4
			(£ million)	
30	APPROXIMATE NET INCOME IN ACCORDANCE WITH ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE UNITED STATES	300	784	186

BARCLAYS PLC

CONSOLIDATED BALANCE SHEET

Note		December 31 1989	 1988
	ASSETS	(£ million)	
9	Cash in hand and with central banks	1,802	1,564
9	Money at call and short notice	10,986	8,635
	British and other government treasury bills	2,963	2,343
	Other bills	1,953	1,826
	Certificates of deposit	2,488	2,782
	Total cash and short-term funds	20,192	17,150
	Items in course of collection from other banks	708	761
10	Securities (market or appraised value – 1989 £1,955 million; 1988 £1,796 million)	1,938	1,770
11	Trading assets of securities business	7,837	4,644
12	Lendings to customers	74,685	63,228
12	Finance lease receivables	4,383	4,012
		79,068	67,240
12	Less allowance for lending losses	(2,499)	(1,655)
		76,569	65,585
	Placings with banks (repayable beyond 30 days)	12,120	9,290
13	Other accounts	5,555	3,304
	Total advances and other accounts	94,244	78,179
14	Investments in associated companies and trade investments	435	348
15	Property and equipment	2,262	1,793
	TOTAL ASSETS	127,616	104,645
	LIABILITIES		
16	Deposits and other borrowings	103,806	87,034
11	Trading liabilities of securities business	7,269	4,208
17	Accrued interest and other liabilities	5,672	3,775
	Current taxes	697	495
18	Deferred taxes	452	658
	Dividend payable	180	145
		118,076	96,315
19	Long-term debt	1,547	1,507
20	Undated capital notes	1,320	996
	TOTAL LIABILITIES	120,943	98,818
	Minority interests	448	116
	SHAREHOLDERS' EQUITY		
21	Issued share capital	1,124	1,114
	Income retained and other reserves	5,101	4,597
		6,225	5,711
	TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	127,616	104,645

See notes 25 and 26 for details of commitments and contingent liabilities and note 30 for approximate shareholders' equity in accordance with accounting principles generally accepted in the United States.

BARCLAYS PLC

CONSOLIDATED STATEMENT OF CHANGES IN INCOME RETAINED AND OTHER RESERVES

Note		Year ended December 31 1989	1988	1987
			(£ million)	
	Balance at beginning of year	4,597	3,451	3,079
	Net income	452	887	204
23	Less dividends	(308)	(256)	[illegible]
	Income retained	144	631	33
	Premium arising on shares issued (net of expenses)	25	565	183
15	Surplus on revaluation of properties	242	–	202
	Exchange rate translation differences	133	(13)	(33)
	Goodwill arising on acquisitions	(33)	(43)	(16)
	Other items	(7)	6	3
	Balance at end of year	5,101	4,597	3,451

	December 31 1989	1988	1987
		(£ million)	
Income retained and other reserves	3,276	3,038	2,429
Surplus on revaluation of properties	867	626	654
Premium arising on shares issued	958	933	368
	5,101	4,597	3,451

Barclays operates in a number of countries which have regulations under which a local subsidiary has to maintain a minimum level of capital. The current policy of Barclays is that local capital requirements are met, as far as possible, by the retention of income. Certain countries operate exchange control regulations which limit the amount of dividends that can be remitted to non-resident shareholders. It is not possible to determine the amount of income retained and other reserves that is restricted by these regulations, but the total consolidated income retained and other reserves of overseas subsidiary and associated companies at December 31, 1989 was £506 million (1988 £349 million, 1987 £354 million). If overseas reserves were to be remitted, further tax liabilities, which have not been provided for in the financial statements, might arise.

BARCLAYS PLC

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

	Year ended December 31 1989	1988	1987
		(£ million)	
ADDITION TO CAPITAL RESOURCES			
Net income	452	887	204
Less dividends	(308)	(256)	[illegible]
Income retained	144	631	33
Shares issued	35	943	228
Surplus on revaluation of properties	242	-	202
Goodwill arising on acquisitions	(33)	(43)	(16)
Minority interests:			
Preference Shares	311	-	-
Other	18	6	9
Undated capital notes issued	200	-	-
Long-term debt (redeemed) issued	(53)	(141)	458
Exchange rate adjustments on capital resources	353	56	443
Other items	(7)	6	3
Net addition to capital resources	1,210	1,458	473
APPLICATION OF CAPITAL RESOURCES			
Property and equipment (including revaluation surplus) less depreciation	469	62	242
Investments in associated companies and trade investments	87	40	13
Added to working resources	654	1,356	218
	1,210	1,458	473
ADDITION TO WORKING RESOURCES			
From capital resources	654	1,356	218
Deposits and other borrowings	16,772	13,173	8,548
Trading liabilities of securities business	3,061	1,331	94
Other liabilities	1,928	828	(262)
	22,415	16,688	8,598
APPLICATION OF WORKING RESOURCES			
Cash and short-term funds	3,042	2,060	1,591
Advances and other accounts	16,065	14,025	6,580
Trading assets of securities business	3,193	1,527	239
Other assets	115	(924)	188
	22,415	16,688	8,598

The effects of acquisitions, disposals and exchange adjustments are included above where appropriate.

A consolidated cash flow statement for 1989 and 1988 is presented in note 31 in a format required by US Statement of Financial Accounting Standards (SFAS) No. 95 as amended by SFAS No. 104.

BARCLAYS BANK PLC

CONSOLIDATED STATEMENT OF INCOME

Note		1989	1988	1987
			Year ended December 31	
			(£ million)	
2	*Interest income*	13 468	9 147	7 633
3	*Interest expense*	(10 048)	(6 181)	(4 962)
	Net interest income	3 420	2 966	2 671
4	*Other operating income*	2 127	1 785	1 550
		5 547	4 751	4 221
5	*Operating expenses*	(3 550)	(3 155)	(2 848)
		1 997	1 596	1 373
12	*Provision for lending losses*	(1 397)	(301)	(1 072)
		600	1 295	301
14	*Share of income before taxes of associated companies*	92	96	68
	INCOME BEFORE TAXES AND MINORITY INTERESTS	692	1 391	369
7	*Applicable taxes*	(215)	(498)	(159)
	Income before minority interests	477	893	210
	Minority interests	(13)	(6)	(6)
	NET INCOME	464	887	204
30	*APPROXIMATE NET INCOME IN ACCORDANCE WITH ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE UNITED STATES*	312	784	186

BARCLAYS BANK PLC

CONSOLIDATED BALANCE SHEET

Note		December 31 1989	December 31 1988
		(£ million)	
	ASSETS		
8	Cash in hand and with central banks	1 802	1 564
9	Money at call and short notice	10 986	8 615
	British and other government treasury bills	2 963	2 343
	Other bills	1 953	1 826
	Certificates of deposit	2 488	2 762
	Total cash and short-term funds	20 192	17 150
	Items in course of collection from other banks	708	761
10	Securities (market or appraised value – 1989 £1 955 million, 1988 £1 796 million)	1 938	1 770
11	Trading assets of securities business	7 837	4 644
12	Lendings to customers	74 685	63 228
12	Finance lease receivables	4 383	4 012
		79 068	67 240
12	Less allowance for lending losses	(2 499)	(1 655)
		76 569	65 585
	Placings with banks (repayable beyond 30 days)	12 120	9 290
13	Other accounts	5 555	3 304
	Total advances and other accounts	94 244	78 179
14	Investments in associated companies and trade investments	435	348
15	Property and equipment	2 262	1 793
	TOTAL ASSETS	127 616	104 645
	LIABILITIES		
16	Deposits and other borrowings	103 806	87 034
11	Trading liabilities of securities business	7 269	4 208
17	Accrued interest and other liabilities	5 672	3 775
	Balances due to Barclays PLC	150	134
	Current taxes	697	495
18	Deferred taxes	452	658
	Dividend payable to Barclays PLC	30	11
		118 076	96 315
19	Long-term debt	1 547	1 507
20	Undated capital notes	1 320	996
	TOTAL LIABILITIES	120 943	98 818
	Minority interests	137	116
	SHAREHOLDERS' EQUITY		
22	Issued share capital	1 705	1 501
	Income retained and other reserves	4 831	4 210
		6 536	5 711
	TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	127 616	104 645

See notes 25 and 26 for details of commitments and contingent liabilities and note 30 for approximate shareholders' equity in accordance with accounting principles generally accepted in the United States.

BARCLAYS BANK PLC

CONSOLIDATED STATEMENT OF CHANGES IN INCOME RETAINED AND OTHER RESERVES

Note		Year ended December 31 1989	 1988 (£ million)	 1987
	Balance at beginning of year	4,210	2,969	2,552
	Net income	464	887	204
24	*Less dividends*	(320)	(256)	(183)
	Income retained	144	631	21
	Premium arising on shares issued (net of expenses)	326	660	–
15	*Surplus on revaluation of properties*	242	–	202
	Capitalisation of revaluation surplus	(195)	–	–
	Cash gift from Barclays PLC	–	–	240
	Exchange rate translation differences	133	(13)	(33)
	Goodwill arising on acquisitions	(33)	(43)	(16)
	Other items	4	6	3
	Balance at end of year	4,831	4,210	2,969

	December 31 1989	 1988 (£ million)	 1987
Income retained and other reserves	3,188	2,939	2,330
Surplus on revaluation of properties	657	611	639
Premium arising on shares issued	986	660	–
	4,831	4,210	2,969

The Barclays Bank PLC Group operates in a number of countries which have regulations under which a local subsidiary has to maintain a minimum level of capital. The current policy of Barclays is that local capital requirements are met, as far as possible, by the retention of income. Certain countries operate exchange control regulations which limit the amount of dividends that can be remitted to non-resident shareholders. It is not possible to determine the amount of income retained and other reserves that is restricted by these regulations, but the total consolidated income retained and other reserves of overseas subsidiary and associated companies at December 31, 1989 was £506 million (1988 £349 million, 1987 £354 million). If overseas reserves were to be remitted, further taxation liabilities, which have not been provided for in the financial statements, might arise.

BARCLAYS BANK PLC

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

	Year ended December 31		
	1989	1988	1987
		(£ million)	
ADDITION TO CAPITAL RESOURCES			
Net income	464	887	204
Dividends payable to Barclays PLC	(308)	(256)	(183)
Dividends payable to holders of Preference Shares	(12)	-	-
Income retained	144	631	21
Shares issued (net of expenses)	335	943	
Cash gift from Barclays PLC	-	-	240
Surplus on revaluation of properties	242	-	202
Goodwill arising on acquisitions	(33)	(43)	(16)
Minority interests in equity of subsidiaries	18	6	-
Undated capital notes issued	200	-	-
Long-term debt (redeemed) issued	(53)	(141)	458
Exchange rate adjustments on capital resources	353	56	(443)
Other items	4	6	3
Net addition to capital resources	1 210	1 458	471
APPLICATION OF CAPITAL RESOURCES			
Property and equipment (including revaluation surplus less depreciation)	469	62	242
Investments in associated companies and trade investments	87	40	11
Added to working resources	654	1 356	218
	1 210	1 458	471
ADDITION TO WORKING RESOURCES			
From capital resources	654	1 356	218
Deposits and other borrowings	16 772	13 173	8 548
Trading liabilities of securities business	3 061	1 331	94
Other liabilities	1 928	828	(262)
	22 415	16 688	8 598
APPLICATION OF WORKING RESOURCES			
Cash and short-term funds	3 042	2 060	1 591
Advances and other accounts	16 065	14 025	6 580
Trading assets of securities business	3 193	1 527	239
Other assets	115	(924)	188
	22 415	16 688	8 598

The effects of acquisitions, disposals and exchange adjustments are included above where appropriate.

A consolidated cash flow statement for 1989 and 1988 is presented in note 31 in a format required by US Statement of Financial Accounting Standards (SFAS) No. 95 as amended by SFAS No. 104.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Summary of Significant Accounting Policies

(a) **Accounting convention**

The financial statements have been prepared in accordance with accounting principles generally accepted in the United Kingdom ("UK GAAP") under the historic cost convention, as modified by the revaluation of certain properties and investments.

(b) **Consolidation**

The consolidated financial statements of Barclays PLC comprise the financial statements of Barclays PLC and its subsidiary companies, and the consolidated financial statements of Barclays Bank PLC comprise the financial statements of Barclays Bank PLC and its subsidiary companies. The financial statements are made up to December 31, except in the case of Barclays Bank of Canada, whose financial statements are made up to October 31 to comply with local legislation, and the securities businesses in the United Kingdom, whose financial statements are made up to the last Stock Exchange account day prior to December 31. Details of the principal subsidiary companies are given in note 27, and of the principal associated companies in note 14.

(c) **Goodwill**

Goodwill arising on acquisitions of subsidiary and associated companies, being the excess of cost over fair value of the Group's share of net tangible assets acquired, is charged against income retained and other reserves in the year of acquisition.

(d) **Investments in associated companies and trade investments**

An associated company is one in which the Group's interest is generally more than 20% and less than 50%.

The consolidated statement of income includes the appropriate share of the results of associated companies based on financial statements made up to dates not earlier than six months before the balance sheet date. Investments in associated companies are included in the consolidated balance sheet at the Group's share of the book value of the net tangible assets of the companies concerned (see also note 14).

A trade investment is an investment in a company, not being a subsidiary or an associated company, in which the Group's interest is for the long term. In the consolidated statement of income, earnings of these companies are included only to the extent of dividend income. Trade investments are stated in the consolidated balance sheet at cost less amounts written off.

(e) **Value of long-term life assurance and pensions policies**

A value (known as the "embedded value") is placed on the existing long-term life assurance and pensions policies written by Barclays Life Assurance Company Limited.

The embedded value is a prudent estimate, based on the advice of a qualified actuary, of the net present value of the profits inherent in such policies, using a discount rate of 15% per annum. Changes in the embedded value are included in the statement of income, grossed up for notional taxation.

The Directors believe that the inclusion of the embedded value more fairly reflects the value to shareholders of the Group's investment in Barclays Life Assurance Company Limited.

NOTES TO FINANCIAL STATEMENTS

(f) Securities

Securities are carried in the consolidated balance sheet on the following bases: securities redeemable at fixed dates purchased with the intention of being held to maturity, at cost, adjusted to give effect to amortisation of premiums and discounts on purchase over periods to redemption; securities redeemable at fixed dates purchased for dealing purposes, at market value; undated investments, at the lower of cost and valuation.

In the securities trading subsidiaries, long and short positions, representing the aggregate of book quantities of individual securities relating to a net bought or a net sold position, are carried at market value and are included in the consolidated balance sheet in trading assets and liabilities of securities business.

(g) Allowance for lending losses

Specific provisions are made against lendings when, in the opinion of the Directors, credit risks or economic and political factors make recovery doubtful. In addition, general allowances are maintained, based on management's evaluation of the portfolios of lendings and other exposures, in respect of losses which, although not specifically identified, are known from experience to be present in any such portfolio. The aggregate provisions which are made during the year (less amounts released and recoveries of bad debts previously written off) are charged against income. Interest on doubtful lendings is normally credited to income and provision made as appropriate. Lendings are charged off in part or in whole when the extent of the loss incurred has been confirmed.

(h) Property and equipment

Property and equipment are stated in the consolidated balance sheet on the basis of cost or appraised value less accumulated depreciation and amortisation. Depreciation is provided on equipment and on plant in all buildings on a straight line basis over five years and ten years respectively. Leasehold properties with less than fifty years of the lease outstanding are depreciated on a straight line basis over the remaining period of the lease.

Depreciation is generally not charged on freehold and long leasehold properties as the Directors do not consider it to be significant in view of the useful economic lives of freehold and long leasehold properties and, having regard to the high standard at which they are maintained, their residual values.

(i) Pension cost

The Group's main pension scheme covers 70% of the Group's employees and is a funded defined benefit scheme. Staff do not make contributions for basic pensions. The pension cost relating to this scheme is assessed in accordance with the advice of a qualified actuary, using the projected unit method. Variations from the regular cost are allocated over the average remaining service lives of current employees.

(j) Finance lease receivables

Finance lease receivables are included in advances and other accounts at the cost of the equipment less amounts charged against rentals to date. Net leasing income under finance leases is taken to income using an actuarial method to give a constant periodic return on the net cash investment.

(k) Deferred tax

Deferred tax is provided at the estimated rates at which future tax will become payable on all timing differences between the accounting and [illegible] treatment of income and expense where, in the opinion of the Directors, it is probable that a liability to tax will crystallise.

NOTES TO FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies (continued)

(l) **Foreign currencies**

Assets and liabilities in foreign currencies are expressed in sterling at rates of exchange ruling on the balance sheet date. Overseas profits and losses are expressed in sterling at average rates of exchange for the year. Profits arising in areas experiencing hyper-inflation are adjusted to recognise its effect on the worth of the working capital employed.

Translation differences arising from the application of closing rates of exchange to the opening net assets held overseas and to related foreign currency borrowings are taken directly to income retained and other reserves. All other exchange profits and losses, which arise from normal trading activities, are included in income.

Presentation of allowance for lending losses

In these financial statements the allowance for lending losses is analysed, where appropriate, between allowances raised in the normal course of business against credit risk and those raised in respect of country risk (i.e. that related to a country's difficulty in servicing the principal or interest of its external debts).

Previously, the country risk category only included allowances in respect of the principal amount of lendings, with allowances raised against outstanding interest being included in the credit risk category. The latter have now been transferred to the country risk category because of their increasing significance, with comparative figures being restated.

US GAAP

Significant differences between accounting principles generally accepted in the United Kingdom and those generally accepted in the United States, and their effect on net income for each of the three years ended December 31, 1989, 1988 and 1987, and on shareholders' equity at December 31, 1989 and 1988, are set out in note 30.

NOTES TO FINANCIAL STATEMENTS

Operations by geographical segment

The analyses of assets, liabilities and profits between the United Kingdom, the United States and the Rest of the World are generally based on the domicile of the office recording the transaction. The United States includes business conducted through the Bahamas and the Cayman Islands. Foreign - UK based amounts include activities in the United Kingdom with overseas customers, including sovereign lendings, and foreign exchange trading business of the Bank arising in the United Kingdom.

The world-wide activities of Barclays are highly integrated and accordingly it is not possible to present geographical segment information without making internal allocations, some of which are necessarily subjective.

Interest on long-term debt and undated capital notes is included in interest expense and is allocated, together with the benefit of an appropriate proportion of shareholders' funds, to the geographical segment using the funds. Central general and administrative costs not directly chargeable to specific areas have been charged to the UK operations of the Bank.

Total assets and total revenues are stated after elimination of intra-group assets and revenues. Intra-group transactions are effected on normal commercial terms.

At December 31, 1989 and December 31, 1988, no single country, apart from the United Kingdom and the United States, accounted for more than 5% of total assets, total revenues, income before taxes and minority interests or net income.

Analyses of lendings are provided in the "Financial Review". Details of deposits and other borrowings, long-term debt and undated capital notes are provided in notes 16, 19 and 20 respectively.

Changes in group structure

A number of acquisitions have been made during the year involving goodwill of £33 million which has been charged against income retained and other reserves.

During the year, Mercantile Group sold a number of its subsidiary companies and the surplus of £28 million arising on their disposal has been included in the Group's results.

In November 1989, the Group agreed, subject to regulatory approval, to sell BarclaysAmerican/Financial, a unit of BarclaysAmericanCorporation, at a price equal to book value plus a premium of $50 million. At December 31 1989, the book value was $112 million. The net gain on sale has not been included in these financial statements.

In February 1990, the Group sold its 32% holding in Yorkshire Bank PLC to National Australia Bank for £312 million. The sale is not reflected in these financial statements which, in 1989, include £36 million in respect of the Group's share of income before taxes of Yorkshire Bank PLC and £112 million in respect of its net assets, including long-term debt, at December 31, 1989. The net gain on sale, after related taxes, will be credited in the 1990 financial statements as an extraordinary item.

Extraordinary General Meeting

An Extraordinary General Meeting is being convened for March 20, 1990, for the purpose, inter alia, of seeking shareholders' approval for amendments to the rules of the UK Profit Sharing Schemes to enable payments to be made in respect of the scheme year 1989. These financial statements have been prepared on the basis of such approval being given, and £66 million has been included in staff expenses for profit sharing.

NOTES TO FINANCIAL STATEMENTS

Note 2 - Interest Income

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Short-term funds	1,716	1,043	851
Securities - listed	134	178	195
- unlisted	37	39	36
Placings with banks	1,292	835	740
Lendings to customers	9,673	6,611	5,412
Lease receivables	616	441	399
	13,468	9,147	7,633

Note 3 - Interest Expense

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Deposits			
In offices in the United Kingdom - Demand	194	117	70
- Savings	1,723	902	723
- Other time	5,388	3,356	2,529
	7,305	4,375	3,322
In offices outside the United Kingdom	2,373	1,486	1,367
	9,678	5,861	4,689
Long-term borrowings of overseas subsidiaries	84	78	83
Long-term debt and undated capital notes	286	242	190
	10,048	6,181	4,962

Note 4 - Other Operating Income

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Commission from banking and related services	1,435	1,283	1,155
Foreign exchange trading income	172	112	113
(Loss) gain on realisation of Government securities	(3)	16	17
Securities trading income	203	145	85
Increase in value of long-term assurance policies	69	50	30
Other income	251	179	150
	2,127	1,785	1,550

Other income includes profit on sale of subsidiary companies of £28 million (1988 £20 million).

Note 5 - Operating Expenses

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Salaries	1,571	1,421	1,259
Pensions, profit sharing and other employee costs (see note 6)	493	[illegible]	417
Property and equipment expenses (see note 15)	626	566	516
Other expenses	860	[illegible]	656
	3,550	3,155	2,848

NOTES TO FINANCIAL STATEMENTS

Note 6 - Pensions, Profit Sharing and Other Employee Costs

Pensions

Pension trust funds were established by the Bank under trust deeds in 1936 and 1964. On October 1, 1986, these two funds merged into one fund known as the Barclays Bank (1964) Pension Fund. The payments made every year to the trust fund are determined on an actuarial basis designed to provide sufficient resources during the working life of full-time employees to pay pensions to them after their retirement and, after their death, to surviving spouses or dependants. Such pensions are based on pensionable salaries (excluding allowances, bonuses and overtime) at or near retirement age, normally 60, and are related to the length of service with the Bank before retirement. Pensions are limited to a maximum of two-thirds of salary for 40 years' service or more. Pensions to surviving spouses of former staff are paid at the rate of 50% of the staff members' pension or potential pension in the case of death before retirement. Staff do not make contributions for basic pensions but may make voluntary contributions on a regular basis to purchase additional service qualification where less than 40 years' service will have been completed by normal retirement age, or to secure pensions based on fringe benefits which are not normally included in the calculation of pensionable salary. The pension funds of certain other subsidiaries are similarly constituted.

The total pension cost for the Group was £166 million (1988 £155 million, 1987 £139 million), of which £130 million (1988 £121 million, 1987 £106 million) related to the Group's main UK pension scheme, £22 million (1988 £20 million, 1987 £16 million) to other UK schemes and £14 million (1988 £14 million, 1987 £17 million) to overseas schemes. Formal actuarial valuations of the main scheme are carried out triennially, the latest being as at March 31, 1987. The principal actuarial assumptions adopted at that valuation were that, over the long term, the annual rate of return on new investments would be 2% higher than the annual increase in total pensionable remuneration, 4½% higher than the annual increase in present and future pensions in payment, and 4½% higher than the annual increase in dividends receivable. The market value of the scheme at the date of the valuation was £3,979 million and the actuarial value of the assets was sufficient to cover 113% of the benefits that had accrued to members, after allowing for expected future increases in earnings. The employer's contribution rate over the average remaining service lives of the members of the scheme takes account of the surplus disclosed by the valuation.

Note 30 provides additional disclosures required by US Statement of Financial Accounting Standards No. 87.

Profit sharing

Barclays has operated a profit sharing scheme based on Group earnings since 1974. Participants in the 1974 scheme (as renewed in 1984) are employees of the Bank, including Executive Directors, and employees of most of its UK subsidiary companies. Participants can elect to take their entitlement, after deduction of income tax, either in cash or in Ordinary Shares of Barclays PLC of the equivalent market value.

Under a related scheme adopted in 1979 and renewed in 1984, participants' entitlements up to a certain annual value (currently £2,000 or 10% of salary, if greater, with a maximum of £6,000) can be received in the form of shares held by trustees for between two and five years in order to obtain a tax advantage for the participant.

The cost of the profit sharing schemes for the year ended December 31, 1989 was £66 million (1988 £69 million, 1987 £44 million). See note 1 - "Extraordinary General Meeting".

Other employee costs

Other employee costs comprise medical health insurance, social welfare taxes, staff transfer and other sundry staff costs.

NOTES TO FINANCIAL STATEMENTS

Note 7 - Applicable Taxes

The charge for applicable taxes comprises

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Current taxes			
United Kingdom	299	320	72
Overseas	73	70	63
Total current taxes	372	390	135
Deferred tax (credit) charge			
United Kingdom	(199)	64	(5)
Overseas	8	1	2
Total deferred taxes	(191)	65	(3)
Associated companies	34	43	27
Total charge	215	498	159

Available overseas tax credits of £24 million (1988 £21 million, 1987 £20 million) are applied to reduce UK tax in accordance with UK tax legislation. Current taxes in the United Kingdom include £37 million (1988 £24 million, 1987 £18 million) in respect of notional tax on franked investment income and on the increase in value of long-term assurance policies. The 1987 charge also includes, for leasing transactions, notional tax of £10 million in respect of regional development grants and certain tax credits which have been grossed up at the average rate applicable to the period of each lease.

Analysis of deferred tax (credit) charge:

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Leasing transactions	(19)	35	(24)
Short-term and other timing differences	(172)	30	21
	(191)	65	(3)

Further information is provided in the "Applicable taxes" section of the Financial Review

NOTES TO FINANCIAL STATEMENTS

Note 8 - Net Income per £1 Ordinary Share - Barclays PLC

Net income expressed per £1 Ordinary Share is calculated after deducting dividends paid on Staff Shares and is related to the weighted average of Ordinary Shares in issue during the year of 1,119 million (1988 1,010 million; 1987 836 million, as restated for the rights issue in May 1988). The exercise of existing options granted under the Executive and Save-as-you-Earn Share Option Schemes would not have a material effect on net income per £1 Ordinary Share.

See note 30 for approximate net income in accordance with accounting principles generally accepted in the United States expressed per £1 Ordinary Share.

Note 9 - Cash and Short-Term Funds

Barclays is required to maintain balances with central banks and other regulatory authorities which, at December 31, 1989, amounted to £462 million (1988 £441 million).

Money at call and short notice comprises interest bearing placings, all repayable within 30 days of the year end. At December 31, 1989, £8,825 million (1988 £7,313 million) was placed with banks and the remainder mainly with discount houses and bill brokers.

Note 10 - Securities

	1989		1988	
	Book value	Market or appraised*	Book value	Market or appraised*
	(£ million)			
Securities of, or guaranteed by, the British Government	573	553	786	770
Other securities listed in Great Britain	34	68	16	24
Securities listed elsewhere	999	995	686	676
	1,606	1,616	1,488	1,470
Unlisted securities	332	339	282	326
	1,938	1,955	1,770	1,796
Securities redeemable at fixed dates:				
At amortised cost	1,535	1,510	1,291	1,266
At market value	285	285	308	308

* Appraised values for unlisted securities are based on Directors' estimates.

The remaining securities are stated at the lower of cost and valuation.

Further analyses of securities are given in the "Securities" section of the Financial Review.

NOTES TO FINANCIAL STATEMENTS

Note 11 - Trading Assets and Liabilities of Securities Business

Assets	1989	1988
	(£ million)	
Long positions at market value	2,418	1,337
Securities purchased under agreements to re-sell	2,168	1,018
Deposits with Stock Exchange money brokers and others as collateral for stock-borrowing	1,014	633
Market and client debtors	2,237	1,556
	7,837	4,544
Liabilities		
Short positions at market value	1,553	656
Securities sold under agreements to re-purchase	2,774	1,208
Secured loans from Stock Exchange money brokers and others	1,028	581
Market and client creditors	1,914	1,763
	7,269	4,208

Note 12 - Lendings to Customers and Allowance for Lending Losses

Analysis is provided within the "Lendings" and the "Allowance for lending losses" sections of the Financial Review. A provision of £983 million was made in 1989 in respect of country risk which is discussed in "Exposures to countries experiencing liquidity problems".

Assets acquired during the year for letting under finance leases amounted to £1,532 million (1988 £1,682 million).

Note 13 - Other Accounts

	1989	1988
	(£ million)	
Accrued interest	1,746	1,154
Items in transit	792	61
Sundry debtors, including prepaid expenses	2,870	1,987
Value of long-term assurance policies	147	102
	5,555	3,304

Items in transit represent transactions within the Bank and its subsidiary companies which have been charged or credited to customers' accounts in particular branches, but not yet credited or charged to accounts held at other branches.

Sundry debtors include £537 million (1988 £459 million) for equipment leased to customers under operating leases, which is net of accumulated depreciation charges of £142 million (1988 £114 million).

NOTES TO FINANCIAL STATEMENTS

Note 14 - Investments in Associated Companies and Trade Investments

	1989 Book value	1989 Market or appraised (i)	1988 Book value	1988 Market or appraised (i)
	(£ million)			
Associated companies				
Listed outside Great Britain	12	14	15	21
Unlisted (ii)	374	575	304	340
	386	589	319	361
Trade investments				
Listed in Great Britain	12	19	6	17
Listed outside Great Britain	2	5	6	7
Unlisted	35	36	17	19
	49	60	29	43
	435	649	348	404

Loans to associated companies, other than normal trading balances, amount to £76 million (1988 £27 million). Dividends from unlisted associated companies amount to £104 million (1988 £14 million). No dividends were received in 1989 or 1988 from listed associated companies.

Dividends from trade investments amount to: listed £1 million (1988 £1 million) and unlisted £2 million (1988 £1 million).

Details of associated companies are as follows:

	Principal area of operation	Percentage of capital held at December 31 1989	Share of income before taxes in respect of the years ended December 31 1989	1988	1987	Equity in net assets at December 31 1989	1988
		%	(£ million)				
Yorkshire Bank PLC (ii)	England	32.0	36	32	28	112	96
3i Group PLC (iii)	England	18.6	32	51	21	111	96
			68	83	49	223	192
Other associated companies			24	13	19	163	127
			92	96	68	386	319

Notes:

(i) Valuation of listed investments is at mid-market prices and that of unlisted investments is at Directors' estimate.

(ii) In February 1990, the Group sold its 32% holding in Yorkshire Bank PLC to National Australia Bank, for £312 million.

(iii) The company is owned by a consortium of UK clearing banks and the Bank of England.

NOTES TO FINANCIAL STATEMENTS

Note 15 - Property and Equipment

	1989			1988		
	Property	Equipment	Total	Property	Equipment	Total
			(£ million)			
Gross book value at beginning of year	1,511	920	2,431	1,471	811	2,282
Exchange and other adjustments	24	13	37	(15)	(15)	(30)
Additions at cost	172	263	435	104	190	294
Disposals	(60)	(127)	(187)	(49)	(66)	(115)
Surplus on revaluation of properties	242	-	242	-	-	-
Gross book value at end of year	1,889	1,069	2,958	1,511	920	2,431
Stated at valuation						
1979 to 1987	187	-	187	1,318	-	1,318
1989	1,512	-	1,512	-	-	-
	1,699	-	1,699	1,318	-	1,318
Stated at cost	190	1,069	1,259	193	920	1,113
Gross book value	1,889	1,069	2,958	1,511	920	2,431
Accumulated depreciation and amortisation	(150)	(546)	(696)	(135)	(503)	(638)
Net book value	1,739	523	2,262	1,376	417	1,793
Net book value of property						
Freehold	1,379			1,079		
Leasehold over 50 years unexpired	218			156		
Leasehold up to 50 years unexpired	142			141		
	1,739			1,376		

The book value of property at December 31, 1989 included £530 million (1988 £427 million) in respect of land.

Property owned by Barclays is revalued when considered appropriate by the Board. At December 31, 1989, the UK properties of Barclays Bank PLC and its property company subsidiary were revalued by the Bank's professionally qualified staff, or by independent professionally qualified valuers, at open market value for existing use or, in the case of specialised properties, at depreciated replacement cost. The surplus of £242 million has been credited to income retained and other reserves.

The net book value of equipment at December 31, 1989 included £15 million (1988 £23 million) of equipment held under finance leases on which depreciation of £8 million (1988 £10 million) was charged in the year.

Depreciation and amortisation of property and equipment included in operating expenses for the year ended December 31, 1989, was £167 million (1988 £161 million, 1987 £150 million).

Profits of £40 million (1988 £27 million, 1987 £9 million) were made on the disposal of properties in the year.

NOTES TO FINANCIAL STATEMENTS

Note 16 - Deposits and Other Borrowings

The following table analyses deposits and other borrowings at December 31, by type:

	1989	1988
	(£ million)	
In offices in the United Kingdom		
Demand deposits - interest free	7 347	8 660
- interest bearing	3 110	1 133
	10 457	9 793
Savings deposits	16 849	13 728
Other time deposits - Retail	13 069	9 591
- Wholesale	32 956	31 937
	73 331	65 049
In offices outside the United Kingdom		
Demand deposits - interest free	1 611	1 418
- interest bearing	2 059	486
	3 670	1 904
Savings deposits	1 241	966
Other time deposits - United States		
Deposits over $100 000	7 365	5 714
Deposits under $100 000	416	451
- Rest of the World	16 936	12 052
	29 628	21 087
Long-term borrowings of overseas subsidiaries	847	898
	103 806	87 034

Included in wholesale deposits in offices in the United Kingdom was commercial paper of £767 million (1988 £632 million). Other time deposits in offices outside the United Kingdom included commercial paper of £2 454 million (1988 £1 493 million).

Deposits in offices in the United Kingdom received from non-residents were £17 952 million (1988 £14 514 million). At December 31, 1989, other time deposits in offices in the United Kingdom, mostly over £25 000, had the following maturities:

	(£ million)	%
Up to 3 months	36 050	78
Over 3 months to 6 months	5 313	12
Over 6 months to 12 months	2 577	6
Over 12 months	2 085	4

NOTES TO FINANCIAL STATEMENTS

Note 16 - Deposits and Other Borrowings (continued)

Long-term borrowings of overseas subsidiary companies are analysed below:

	1989	1988
	(£ million)	
Borrowings wholly repayable within five years		
Notes at fixed rates between 7.85% and 12.0% (1988 between 7.55% and 13.8%) $438 million (1988 $574 million)	272	318
Zero coupon notes 1990 $200 million (1988 $200 million) less unamortised discount $21 million (1988 $45 million)	112	85
Loan at variable rate (minimum 11%) 1990 Fr.Fr. 124 million (1988 Fr.Fr. 149 million)	13	14
Loan at variable rate (minimum 10⅝%) 1991 Fr.Fr. 109 million (1988 Fr.Fr. 121 million)	12	11
Loan at variable rate (minimum 6½%) 1993 Fr.Fr. 529 million (1988 Fr.Fr. 444 million)	57	41
Loan at variable rate (minimum 6¼%) 1994 Fr.Fr. 437 million (1988 Fr.Fr. 500 million)	47	46
Other borrowings		
Notes at fixed rates between 8.125% and 8.75% (1988 between 7.625% and 12%) repayable by 1999 $234 million (1988 $497 million)	158	275
Notes at fixed rates between 8⅝% and 9¾% Fr.Fr. 1,385 million (1988 Fr.Fr. 925 million)	148	84
Notes at variable rates based on Paris Interbank Offer Rate Fr.Fr. 265 million (1988 Fr.Fr. 265 million)	28	24
	847	898

Of the total borrowings, £542 million (1988 £678 million) is denominated in dollars and £305 million (1988 £220 million) in French Francs.

Borrowings include £112 million (1988 £85 million) in respect of zero coupon notes, denominated in dollars, with a nominal value of $200 million, issued in 1981 at a discount which is being amortised as interest giving an effective rate of 15¼% p.a. over the life of the notes.

Long-term borrowings of overseas subsidiary companies comprise unsecured notes used to finance their operations and had maturities at December 31, 1989 as follows:

	(£ million)
1990	164
1991	81
1992	69
1993	159
1994	51
	524
Thereafter	323
	847

Interest on amounts wholly repayable within five years was £50 million (1988 £46 million).

NOTES TO FINANCIAL STATEMENTS

Note 17 - Accrued Interest and Other Liabilities	**1989**	**1988**
	(£ million)	
Sundry creditors	2 540	2 070
Accrued interest	1 742	1 009
Accrued expenses	576	480
Items in transit (see note 13)	504	19
Obligations under finance leases		
Payable within one year	144	122
Payable between one year and five years	221	98
	365	220
Future finance charges	(55)	(23)
	310	197
	5 672	3 775

Note 18 - Deferred Taxes

Account is taken of timing differences between the accounting and tax treatment of certain items where, in the opinion of the Directors, it is probable that a liability to tax will crystallise.

Deferred tax liabilities provided in the financial statements are computed at the estimated rates at which future tax will become payable. Movements on deferred taxes during the year are as follows:

	1989	**1988**
	(£ million)	
Balance at beginning of year	658	572
Exchange and other movements	(15)	21
(Credit) charge to income (see note 7)	(191)	65
Balance at end of year	452	658

The following table analyses deferred tax provided at December 31:

	1989	**1988**
	(£ million)	
Leasing transactions	564	584
Other timing differences	(112)	74
	452	658

The credit to income in 1989 arises from the release of £54 million deferred taxes in respect of leasing transactions, with the remainder principally relating to country risk provisions made in the year, tax relief for a portion of which has been assumed to be available in future years.

Potential tax liabilities in respect of leasing transactions not provided in the financial statements and computed at estimated future tax rates amount to £153 million (1988 £97 million).

No tax is provided on capital gains which might arise on the disposal of Group subsidiary or associated companies at their balance sheet amounts. Further, no provision is made for tax on capital gains which might arise on the disposal of properties at their balance sheet amounts, as the Directors are of the opinion that, in view of the substantial number of properties involved and the law relating to rollover relief, the likelihood of any such material tax liability arising is remote and no useful purpose would be served by attempting to quantify it.

NOTES TO FINANCIAL STATEMENTS

Note 19 - Long-term Debt

Long-term debt (loan capital) is raised by the Bank and its finance subsidiaries for the development and expansion of the Group's business.

Description	Repayment Terms	Maturity Date	1989	1988
			(£ million)	
The Bank				
7¼% Unsecured Capital Loan Stock 1986/91	(i)	1991	7	7
8¼% Unsecured Capital Loan Stock 1986/93	(i)	1993	59	59
10¼% Senior Subordinated Bonds 1997		1997	250	250
Floating Rate Unsecured Capital Loan Stock 2006	(i) (iii)	2006	18	19
16% Unsecured Capital Loan Stock 2002/07	(i)	2007	100	100
12% Unsecured Capital Loan Stock 2010		2010	132	150
BOIC				
9¼% Guaranteed Bonds 1995 (1988 $55 million)		-	-	31
8% Guaranteed Bonds 1996 (Yen 40 000 million (1988 Yen 40 000 million))		1996	173	177
8⅝% Unsecured Bearer Bonds 1983/98 (DM 250 million (1988 DM 250 million))	(i) (iii)	1998	92	78
Guaranteed Floating Rate Notes 2004 ($350 million (1988 $350 million))	(i) (iv)	2004	218	194
BNACC				
11⅝% Guaranteed Capital Notes 2003 ($400 million (1988 $400 million))	(i)	2003	249	221
10¼% Guaranteed Capital Notes 2017 ($400 million (1988 $400 million))	(i)	2017	249	221
			1 547	1 507

Long-term debt of the Bank has been issued on the basis that the claims thereunder are subordinated to the claims of depositors and other unsecured unsubordinated creditors. Long-term debt issued by Barclays Overseas Investment Company B.V. ("BOIC") and Barclays North American Capital Corporation ("BNACC") carries the guarantee of the Bank, which is subordinated on a similar basis.

The notes issued by BNACC have been registered under the US Securities Act of 1933. The dollar obligations of the Bank and BOIC, which were issued in the eurocurrency market, have not been so registered.

The debt obligations of the Bank, BOIC and BNACC rank ahead of the interests of holders of their equity

NOTES TO FINANCIAL STATEMENTS

As at December 31, 1989, all long-term debt issued by BOIC has been on-lent to the Bank on a subordinated basis. The proceeds from issuing the 6% Guaranteed Bonds 1996 Yen 40,000 million (£173 million, 1988 £177 million) were swapped into $255 million (£159 million, 1988 £141 million) before on-lending to the Bank. Of the long-term debt issued by BNACC, $790 million has been on-lent to the Bank on a subordinated basis.

The Guaranteed Floating Rate Notes 2004 and the Floating Rate Unsecured Capital Loan Stock 2006 bear interest at rates fixed in advance for periods of six months. At December 31, 1989, the rates were 9 1/16% (1988 9 1/16%) on the 2004 Notes and 14 5/8% (1988 13%) on the 2006 Capital Loan Stock.

Since December 31, 1989, £32 million of the 12% Unsecured Capital Loan Stock 2010 has been redeemed.

Interest on long-term debt wholly repayable within five years amounts to £5 million (1988 £9 million).

Repayment Terms

Repayable (in whole or in part) at the option of the issuer, prior to maturity, on conditions governing the respective debt obligations.

(ii) Holders of the Floating Rate Unsecured Capital Loan Stock 2006 have certain cumulative rights to call for redemption of their holdings.

(iii) The DM 250 million 8¼% Unsecured Bearer Bonds 1983/98 are repayable in five instalments of DM 50 million each, payable on December 1 of each of the years 1994 to 1998.

(iv) The $350 million Guaranteed Floating Rate Notes 2004 are repayable in five annual instalments on the interest payment date falling in March in each of the years 2000 to 2004.

Maturities and purchase fund requirements

Based on final maturity dates, aggregate maturities and purchase fund requirements over the next five years and thereafter are as follows:

	(£ million)
1990	-
1991	7
1992	-
1993	59
1994	-
	66
Total thereafter	1,481
	1,547

NOTES TO FINANCIAL STATEMENTS

Note 20 - Undated Capital Notes

Undated capital notes are issued by the Bank and its finance subsidiaries for the development and expansion of the Group's business and to strengthen its capital base and comprise

	1989	1988
	(£ million)	
The Bank		
Undated Floating Rate Primary Capital Notes Series 1 $600 million (1988 $600 million)	373	332
Undated Floating Rate Primary Capital Notes Series 2 $793 million (1988 $750 million)	493	415
Undated Floating Rate Primary Capital Notes Series 3	200	-
BOIC		
Junior Guaranteed Undated Floating Rate Notes $407 million (1988 $450 million)	254	249
	1 320	996

The Undated Floating Rate Primary Capital Notes Series 1, issued in 1985, the Undated Floating Rate Primary Capital Notes Series 2, issued in 1986 and 1989, and the Undated Floating Rate Primary Capital Notes Series 3, issued in 1989, bear interest fixed at ¼% or ½% above rates determined by reference to the London inter-bank market for each interest period. The Notes may not be called by the Bank during the first five years of issue (except for tax reasons) and interest is payable at the Bank's option during any period in which dividends have not been declared or paid on any class of share of Barclays PLC. Payment of principal or interest is subject to the Bank satisfying a specified solvency test. There are no events of acceleration except non-payment of principal or mandatory interest. Undated Floating Rate Primary Capital Notes of the Bank rank behind the claims of the holders of the Junior Guaranteed Undated Floating Rate Notes.

The Junior Guaranteed Undated Floating Rate Notes, issued by BOIC in 1984, bear interest determined in a manner similar to that for the Undated Floating Rate Primary Capital Notes. The Junior Guaranteed Undated Floating Rate Notes carry the junior subordinated guarantee of the Bank, ranking behind the claims against the Bank of depositors and other unsecured unsubordinated creditors and holders of long-term debt. The proceeds of this issue have been on-lent to the Bank on similar terms.

During 1989, the Bank exchanged $43 million of Junior Notes for an equal principal amount of further Undated Floating Rate Primary Capital Notes Series 2.

Undated Capital Notes (other than Primary Capital Notes Series 3) bear interest at rates fixed in advance for periods of six months. At December 31, 1989, the rates were 9⁵⁄₁₆% (1988 8¼%) on the Primary Capital Notes Series 1, 9 [illegible]⁄₁₆% (1988 9¼%) on the Primary Capital Notes Series 2 and 8¹³⁄₁₆% (1988 8⅞%) on the Junior Floating Rate Notes. The Primary Capital Notes Series 3 bear interest at a rate fixed in advance for periods of three months and, at December 31, 1989, the rate was 15⅝%.

Interest on undated capital notes amounts to £116 million in 1989 (1988 £83 million).

NOTES TO FINANCIAL STATEMENTS

Note 21 - Issued Share Capital - Barclays PLC

The creation in 1988 of 600 million Ordinary Shares of £1 each increased the authorised share capital of Barclays PLC to £1,500 million, comprising 1,499 million Ordinary Shares of £1 each and 1 million Staff Shares of £1 each.

	1989	1988	1987
		(£ million)	
Issued Ordinary share capital, allotted and fully paid			
At beginning of year	1,113.5	735.5	690.2
Issued by way of rights issue	-	369.1	-
Issued by public offering	-	-	41.5
Issued to staff under profit sharing schemes			
at 506p per £1 share	-	-	2.5
at 479p per £1 share	-	2.6	-
at 439p per £1 share	4.4	-	-
Issued to staff under share option schemes at varying prices (see below)	3.6	6.3	1.3
Share dividend alternative	1.7	-	-
At end of year	1,123.2	1,113.5	735.5
Staff share capital, allotted and fully paid	0.9	0.9	0.9
	1,124.1	1,114.4	736.4

In May 1988, a rights issue was made on the basis of one new Ordinary Share at the price of £2.50 for every two Ordinary Shares held. 369.1 million new Ordinary Shares of £1 each were thus allotted for a total consideration of £920 million (net of issue expenses). As a result of the rights issue, the number of shares subject to options outstanding at December 31, 1987 was increased by 5.1 million; the prices at which the options could be exercised were also adjusted.

In May 1987, 41.5 million Ordinary Shares were issued for a consideration of £213 million, net of expenses, following an offering in the United States and Japan. American Depositary Shares, each representing four Ordinary Shares, were offered in the United States and Ordinary Shares were offered in Japan.

It is not yet possible to quantify the amount which will be issued in 1990 under the UK profit sharing schemes in respect of allocations of Ordinary Shares arising from profit in 1989.

Under the terms of the Executive and Save-as-you-Earn Share Option Schemes, 31.1 million (1988 36.0 million) options are outstanding, enabling certain Directors and members of staff to subscribe for Ordinary Shares between 1990 and 1999, at prices ranging from 220p to 514p per share.

See also "Business description - Recent developments" for details of a proposed capitalisation issue and a proposal to enable Barclays PLC to purchase its own Ordinary Shares.

NOTES TO FINANCIAL STATEMENTS

Note 22 - Issued Share Capital - Barclays Bank PLC

Ordinary Shares

The authorised Ordinary share capital of the Bank at December 31, 1989, was 2,000 million (1988 2,000 million) Ordinary Shares of £1 each. On February 28, 1990, the authorised Ordinary share capital was increased to £2,500 million Ordinary Shares of £1 each.

	1989	1988	1987
		(£ million)	-
Issued Ordinary share capital, allotted and fully paid:			
At beginning of year	1,501	1,218	1,218
Issued for cash	9	283	-
Bonus issue by capitalisation of reserves	195	-	-
At end of year	1,705	1,501	1,218

On February 28, 1990, a further 255 million Ordinary Shares were issued by capitalisation of reserves.

Preference Shares

The authorised Preference share capital of the bank is 60 million (1988 nil) Preference Shares of $0.01 each. In 1989 the Bank issued 20 million Non-cumulative Dollar-denominated Preference Shares in two series, Series A and Series B, for a total consideration of $500 million, of which $200,000 was the nominal value and the balance was share premium.

	Series A	Series B
Number of shares issued	12,650,000	7,350,000
Nominal value per share	$0.01	$0.01
Premium per share	$24.99	$24.99
Liquidation value per share	$25.00	$25.00

The Series A Preference Shares are redeemable at the option of the Bank from June 2, 1994, initially at a price of $26.39 per share, decreasing to $25.00 per share on June 2, 1999 and thereafter, and the Series B Preference Shares are redeemable at the option of the Bank from July 7, 1994, initially at a price of $26.38 per share, decreasing to $25.00 per share on July 7, 1999 and thereafter, plus in each case accrued dividends.

NOTES TO FINANCIAL STATEMENTS

Note 23 - Dividends - Barclays PLC

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Ordinary Shares			
First interim	128	111	77
Second interim	180	145	94
	308	256	171
		(pence per £1 share)	
First interim	11.40	10.00	9.01
Second interim	16.00	13.00	10.93
	27.40	23.00	19.94

Dividends amounting to £0.1 million are payable on the Staff Shares which carry a fixed dividend of 14% per annum unless no dividend is paid for the year on the Ordinary Shares.

Comparative figures have been restated to take account of the rights issue in 1988.

Note 24 - Dividends - Barclays Bank PLC

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Ordinary Shares			
First interim	128	111	13
Second interim	150	134	79
Third interim (1989 and 1988 proposed)	30	11	74
Fourth interim (1987 proposed)	-	-	17
	308	256	183

These dividends are paid to enable Barclays PLC to fund its dividends to its shareholders.

During 1989, two series of Non-cumulative Dollar-denominated Preference Shares, Series A and Series B, were issued. Dividends on the Preference Shares are paid quarterly at rates of the liquidation value of $25 per share which, when grossed up for the UK associated tax credit, represent 11.120% per annum on Series A shares and 10.875% per annum on Series B shares. In 1989, Preference Share dividends paid totalled $19 million (£12 million).

NOTES TO FINANCIAL STATEMENTS

Note 25 - Lease Commitments

At December 31, 1989 Barclays held various leases of land and buildings, many for extended periods, and other leases of equipment, which require aggregate rental payments as follows

Year ended December 31	(£ million)
1990	138
1991	130
1992	119
1993	111
1994	108
Total thereafter	1,857

Rentals for leasehold land and buildings and for equipment included in operating expenses for the year ended December 31, 1989 were £172 million (1988 £137 million; 1987 £118 million).

Note 26 - Other Commitments and Contingent Liabilities

Commitments not provided for in these financial statements for capital expenditure under contract amount to £88 million (1988 £98 million) and for capital expenditure authorised but not contracted amount to £210 million (1988 £59 million).

Contingent liabilities, for which there are counter-liabilities of customers, amounted at December 31, 1989 to £14,069 million (1988 £12,262 million). These items, which are not reflected on the consolidated balance sheets, may be analysed between financial guarantees and other.

Financial guarantees arise when the Bank and its subsidiary companies, in the normal course of business, make commitments which are contractual obligations on behalf of their customers. These commitments take the form of guarantees and indemnities and letters of credit in favour of third parties whereby the Bank and its subsidiary companies agree to make payments for customers' accounts under certain conditions or in the event of default by the customer. The service provided through these commitments normally requires the payment of a fee. Financial guarantees at December 31 totalled £7,993 million (1988 £9,517 million), of which £2,664 million (1988 £2,869 million) related to acceptances.

Other contingent liabilities, which include performance bonds and documentary credits, amounted at December 31 to £6,076 million (1988 £2,745 million). The majority of these facilities are offset by corresponding obligations of third parties. In addition, there are interest rate and currency swaps, financial futures contracts, forward contracts for the purchase and sale of foreign currencies, option contracts and various other facilities to customers which are not reflected in the consolidated balance sheet.

For further discussions of off-balance sheet items see "Capital Resources".

The Bank and its subsidiary companies may withdraw from their contractual obligations in respect of the undrawn portion of agreed overdraft limits at any time by giving reasonable notice to the customer.

It is not envisaged that any of the above will have a material adverse effect on consolidated net income or shareholders' equity.

Barclays is also party to various legal proceedings arising in the ordinary course of business (see "Legal Proceedings").

NOTES TO FINANCIAL STATEMENTS

Note 27 - Principal Subsidiary Companies of Barclays PLC

Country of registration or incorporation	Principal subsidiary companies at December 31, 1989	Percentage of equity capital held
England	Barclays Bank PLC - ordinary shares	100 *
England	Barclays de Zoete Wedd Holdings Limited - ordinary shares	100
England	Barclays Financial Services Limited	100
England	Mercantile Group Plc	100
Guernsey	Barclays Finance Company (Guernsey) Limited	100
Jersey	Barclays Bank Finance Company (Jersey) Limited	100
France	Barclays Bank SA	100
Italy	Barclays Financial Services Italia SpA	100
Spain	Barclays Bank SAE	88.1
Switzerland	Barclays Bank (Suisse) SA	100
Botswana	Barclays Bank of Botswana Limited	80.4
Kenya	Barclays Bank of Kenya Limited	68.5
Zimbabwe	Barclays Bank of Zimbabwe Limited	100
USA	BarclaysAmericanCorporation	100 *
USA	Barclays Bank of New York N.A.	99.9 *
Canada	Barclays Bank of Canada	100
Australia	Barclays Bank Australia Limited	100

The country of registration or incorporation is also the principal area of operation for each of the above companies. Investments in these companies are held directly by Barclays Bank PLC except where marked *.

Barclays Bank PLC also has in issue 20 million Non-cumulative Dollar-denominated Preference Shares of $0.01 each, none of which are held by Barclays PLC.

The Bank also holds 24% of the issued non-redeemable cumulative preference shares (Founders Shares) of Barclays de Zoete Wedd Holdings Limited.

For subsidiary and associated companies operating in countries where there is doubt as to the timely remittance of profits, the consolidated income before taxes and minority interests includes only amounts which have been received in the United Kingdom, and the Group's investment is carried in the balance sheet at the lower of cost and valuation. The Group's share of income before taxes thus excluded from the income before taxes reported for the year is £11 million (1988 £8 million, 1987 £18 million). Net assets of subsidiary and associated companies excluded from the consolidated balance sheet amount to £27 million (1988 £33 million).

NOTES TO FINANCIAL STATEMENTS

Note 28 - Operations by Geographical Segment

	December 31					
	1989		1988		1987	
Total assets	£ million	%	£ million	%	£ million	%
United Kingdom	78 463	61	68 005	65	53 881	61
Foreign						
UK based	10 282	8	7 874	8	8 740	10
United States	16 254	13	12 794	12	11 035	13
Rest of the World	22 617	18	15 872	15	14 199	16
	49 153	39	36 540	35	33 974	39
	127 616	100	104 545	100	87 855	100
Total revenues (1)						
United Kingdom	10 582	68	7 521	69	5 862	64
Foreign						
UK based	1 284	8	784	7	807	9
United States	1 468	9	1 139	10	1 166	13
Rest of the World	2 261	15	1 488	14	1 348	14
	5 013	32	3 411	31	3 321	36
	15 595	100	10 932	100	9 183	100
Income before taxes and minority interests						
United Kingdom	1 411	204	1 184	85	855	232
Foreign						
UK based	(873)	(126)	88	6	(620)	(168)
United States	72	10	43	3	64	17
Rest of the World	82	12	76	5	70	19
	(719)	(104)	207	15	(486)	(132)
	692	100	1 391	100	369	100
Net income (2)						
United Kingdom	953	211	754	85	548	269
Foreign						
UK based	(576)	(127)	86	10	(401)	(197)
United States	47	10	21	2	35	17
Rest of the World	28	6	26	3	22	11
	(501)	(111)	133	15	(344)	(169)
	452	100	887	100	204	100

Notes

(1) Total assets and total revenues are stated after elimination of intra-group assets and revenues. Intra-group transactions are effected on normal commercial terms.

(2) Net income analysed above is that of Barclays PLC. Net income of Barclays Bank PLC differs only in 1989 as a result of the dividends on its Preference Shares (issued in 1989) of £12 million. These are treated as minority interests in Barclays PLC and so are deducted before arriving at Barclays PLC's net income.

NOTES TO FINANCIAL STATEMENTS

Note 29 - Condensed Financial Statements of Barclays PLC (Parent Company Only)

Statement of Income and Changes in Income Retained and Other Reserves

	Year ended December 31		
	1989	1988	1987
	(£ million)		
Dividend income from the Bank (note 24)	308	256	183
Dividends payable to shareholders (note 23)	308	256	171
Change in income retained	-	-	12
Income retained brought forward	881	881	869
Income retained carried forward	881	881	881

Balance Sheet

	December 31	
	1989	1988
	(£ million)	
Assets		
Investment in the Bank	6,225	5,711
Amounts receivable from the Bank		
Dividend	30	11
Other amounts	150	134
Total assets	6,405	5,856
Liabilities		
Dividend payable	180	145
Shareholders' equity		
Issued share capital	1,124	1,114
Share premium	958	933
Revaluation reserve	3,262	2,783
Income retained	881	881
	6,225	5,711
Total liabilities and shareholders' equity	6,405	5,856

NOTES TO FINANCIAL STATEMENTS

Note 30 - Differences Between UK and US Accounting Principles

The financial statements presented in this report have been prepared in accordance with accounting principles generally accepted in the United Kingdom (UK GAAP). Such principles vary in significant respects from those generally accepted in the United States (US GAAP). The significant differences applicable to Barclays financial statements are summarised below (see also note 31).

	UK GAAP	US GAAP
Goodwill	Goodwill arising on acquisitions of subsidiary and associated companies is charged against income retained in the year of acquisition.	Goodwill is capitalised and amortised through income over the period estimated to benefit. In Barclays case, a period of 20 years has been used. Goodwill is written off when judged to be irrecoverable.
Leasing	Finance lease income is recognised in proportion to the funds invested in the lease using a method which results in a level rate of return on the net cash investment.	Application of Statement of Financial Accounting Standards ("SFAS") No. 13 gives rise to a level rate of return on the investment in the lease, but without taking into account tax payments and receipts. This results in income being recognised in different periods than under UK GAAP.
Deferred tax	Deferred tax is provided at the estimated rates at which future tax will become payable on timing differences where it is probable that a tax liability will crystallise. No deferred tax asset is created in respect of general allowances for lending losses, which are not deductible in arriving at UK taxable profits.	The full deferral method is used whereby tax is provided on all timing differences using the rates of tax in force at the time the provision is made. (see "Future developments".) A deferred tax asset is created in respect of general allowances for lending losses to the extent considered to be realisable.
Property depreciation	Depreciation is generally not charged by Barclays on freehold and long leasehold properties as their estimated useful economic lives and residual values make it insignificant.	Freehold and long leasehold property is depreciated over 50 years.
Loan origination fees and costs	Loan origination fees and costs are generally taken to income as they arise.	SFAS No. 91 was adopted prospectively on January 1, 1988 and requires fees and direct costs associated with the origination of lendings, guarantees or commitments to be recognised as an adjustment of yield over the life of the lending.
Debt swaps	Debts acquired via a debt swap transaction are recorded at face value and an allowance is raised, where necessary, to reduce this value to Barclays estimate of the ultimate recoverable amount.	Debts acquired through a debt swap transaction are recorded at estimated fair value at the date of the transaction, and an allowance is raised, where necessary, to reduce this value to Barclays estimate of the ultimate recoverable amount.

UK GAAP	US GAAP
Long-term assurance policies Long-term assurance policies are valued at the net present value of the profits inherent in such policies.	The net present value of inherent profits of long-term assurance policies is not recognised by Barclays under US GAAP.
Pension cost Pension fund assets are assessed actuarially at the present value of the expected future investment income, which is consistent with UK Statement of Standard Accounting Practice 24. Most liabilities are discounted at a long-term interest cost. Most variations from regular cost are expressed as a percentage of payroll and spread over the average remaining service lives of current employees.	Under SFAS No. 87, the same basic actuarial method is used as under UK GAAP, but certain assumptions differ: assets are assessed at fair value and liabilities are assessed at current settlement rates. Certain variations from regular cost are allocated in equal amounts over the average remaining service lives of current employees.
Revaluation of property Property is carried either at original cost or at subsequent valuation less related depreciation, calculated on the revalued amount where applicable. Revaluation surpluses and deficits are taken directly to shareholders' equity.	Revaluations of property are not permitted in the financial statements under US GAAP. As a result, when a property is disposed of, a greater profit is generally recorded under US GAAP than under UK GAAP.
Dividend payable Dividends declared after the period end are recorded in the period to which they relate.	Dividends are recorded in the period in which they are declared.
Acceptances Acceptances are not recorded on the balance sheet (see note 26).	Acceptances and the related customer liabilities are recorded on the balance sheet.

Future developments

The US Financial Accounting Standards Board ("FASB") issued SFAS No. 96, "Accounting for Income Taxes" in December 1987. This SFAS requires a change in accounting for deferred tax from a deferral method to a liability method. The SFAS was originally effective for financial statements for fiscal years beginning after December 15, 1988. SFAS No. 100, issued in December 1988, deferred the effective date of this change to fiscal years beginning after December 15, 1989 and SFAS No. 103, issued in December 1989, further deferred the effective date to fiscal years beginning after December 15, 1991. Barclays continues to review the statements to determine what effect they may have on the reconciliation of net income and shareholders' equity between UK and US GAAP.

The FASB has issued an Exposure Draft ("ED"), "Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentration of Credit Risk". The ED will extend disclosure relating to financial instruments. In particular, it requires a discussion and quantification of the risk associated with off-balance sheet financial instruments and disclosure of any significant concentrations of credit risk. The ED's requirements are expected to become effective for fiscal years ending after December 15, 1990.

An ED on "Employers' Accounting for Postretirement Benefits Other Than Pensions" was issued in February 1989. It addresses recognition and measurement issues involved in an employer's obligation to provide postretirement benefits other than pensions for its employees, and would change accounting practice from the currently prevalent pay-as-you-go basis to an accrual basis. The proposals of the ED would not impact the majority of Barclays operations until 1994.

NOTES TO FINANCIAL STATEMENTS

Note 30 - Differences Between UK and US Accounting Principles (continued)

The following table summarises the significant adjustments to consolidated net income and shareholders' equity which would result from the application of US GAAP instead of UK GAAP.

	Year ended December 31		
	1989	1988	1987
		(£ million)	
Net income of Barclays PLC as in the consolidated statement of income	452	887	204
Goodwill	(43)	(17)	(15)
Leasing (i)	(21)	(46)	35
Deferred tax	(54)	(17)	(57)
Property depreciation	(7)	(6)	5
Loan origination fees and costs	(18)	(26)	-
Debt swaps	11	(12)	-
Long-term assurance policies	(45)	(33)	15
Pension cost (v)	10	27	-
Disposal of revalued property	15	27	-
Barclays PLC Group - Approximate net income in accordance with accounting principles generally accepted in the United States	300	784	186
Preference share dividends of Barclays Bank PLC	12	-	-
Barclays Bank PLC Group - Approximate net income in accordance with accounting principles generally accepted in the United States	312	784	186
		(pence)	
Net income per £1 Ordinary Share (see note 8)			
Barclays PLC Group	26.8	77.6	22.2

	Barclays PLC Group December 31		Barclays Bank PLC Group December 31	
	1989	1988	1989	1988
	(£ million)		(£ million)	
Shareholders' equity as in the consolidated balance sheet	6,225	5,711	6,536	5,711
Goodwill	233	247	233	247
Leasing (i)	15	36	15	36
Deferred tax (iii)	(123)	(66)	(123)	(66)
Property depreciation	(27)	(20)	(27)	(20)
Loan origination fees and costs	(44)	(26)	(44)	(26)
Debt swaps	(1)	(12)	(1)	(12)
Long-term assurance policies	(147)	(102)	(147)	(102)
Pension cost (v)	37	27	37	27
Revaluation of property (iv)	(876)	(635)	(876)	(635)
Proposed dividend	180	145	30	11
Approximate shareholders' equity in accordance with accounting principles generally accepted in the United States	5,472	5,305	5,633	5,171

NOTES TO FINANCIAL STATEMENTS

Notes:

(i) The leasing adjustment is dependent upon the value and average age of the leasing portfolio at each period end.

(ii) Debt swaps involved loans with country risk with a face value of £412 million in 1989. The £1 million adjustment to shareholders' equity represents the cumulative amount, net of tax, by which Barclays estimate of the ultimate recoverable value of debts acquired through swaps exceeds the estimated fair value of such debts. The reduction in the adjustment in 1989 reflects the significant provisions against country risk made during the year.

(iii) The adjustment to shareholders' equity in respect of deferred tax is made up as follows:

	December 31	
	1989	1988
	(£ million)	
Deferred tax not provided relating to leasing	(153)	(97)
Deferred tax asset arising from general allowance	50	44
Change from UK liability to US deferral method	(5)	(4)
Deferred tax not provided on profits from disposal of revalued property	(15)	(9)
	(123)	(56)

(iv) In 1989 Barclays Bank PLC capitalised £195 million of its property revaluation reserve by the issue of bonus shares to Barclays PLC. As US GAAP does not permit property to be revalued, the shareholders' equity reconciliation has been adjusted for the full amount of revaluation included in the book value of the property of the Group.

(v) SFAS No. 87 "Employers' Accounting for Pensions" was first adopted in 1988 for the purpose of identifying significant differences between US and UK GAAP. Under SFAS No. 87, the excess of plan assets over the projected benefit obligation, as at the transition date, is recognised as a reduction of pension expense on a prospective basis over approximately 15 years.

The provisions of SFAS No. 87 have only been applied to the main UK pension scheme, the Barclays Bank (1964) Pension Fund. This scheme makes up over 90% of all the Group's schemes in terms of assets and actuarial liabilities.

The components of the 1989 pension expense which arise under SFAS No. 87 are estimated to be as follows:

	Year ended December 31	
	1989	1988
	(£ million)	
Service cost	180	148
Interest cost	353	304
Actual return on plan assets	(1,098)	(592)
Other components	679	219
	114	79

The £114 million US GAAP pension cost (1988 £79 million) compares with £130 million under UK GAAP (1988 £121 million). The difference, net of UK corporation tax at 35%, represents the £10 million net income adjustment for 1989 (1988 £27 million).

NOTES TO FINANCIAL STATEMENTS

Note 30 - Differences Between UK and US Accounting Principles (continued)

Notes

continued

The following table presents the estimated funded status of the scheme under SFAS No. 87.

	As at September 30 1989	As at September 30 1988
	(£ million)	
Plan assets at fair value	5 222	4 151
Accumulated benefit obligation - vested and non-vested	3 110	2 772
Additional benefits based on estimated future salary levels	956	1 016
Projected benefit obligation	4 066	3 788
Plan assets in excess of projected benefit obligation	1 156	363
Amounts available to be applied as (reduction) increase of future pension cost		
Balance of initial transition amount	(343)	(369)
Accumulated actuarial difference	(755)	48
Prepaid pension cost	58	42

Plan assets are invested primarily in equities, fixed interest securities and property.

The calculation of the US GAAP 1989 pension expense and the projected benefit obligation at September 30, 1989 assumes a weighted average discount rate in accordance with SFAS No. 87 of 9.50%. The other main assumptions are the same as those used for the purposes of UK GAAP and are explained in note 6 to the financial statements.

Note 31 - Consolidated Statement of Cash Flows

The cash flow statement below presents information in a format required by SFAS No. 95, as amended by SFAS No. 104.

For purposes of this statement "Cash and cash equivalents" comprises total cash and short-term funds less certificates of deposit.

The effects of acquisitions, disposals and exchange adjustments are included where appropriate.

Interest paid in the year was £9,315 million (1988 £5,971 million) and corporation tax paid in the year was £204 million (1988 £219 million).

Barclays Bank PLC

A consolidated cash flow statement for Barclays Bank PLC would be identical to that presented below for Barclays PLC except as follows:

- Dividends on ordinary shares were paid at different dates, and the year-end dividend accrual is different (see notes 23 and 24).
- In 1989, the increase in minority interests in Barclays PLC Group includes the proceeds of the $500 million Preference Share issue by Barclays Bank PLC.
- Barclays PLC Group net income is arrived at after deducting £12 million minority interest relating to dividends on Preference Shares issued by Barclays Bank PLC.

NOTES TO FINANCIAL STATEMENTS

Barclays PLC	Year ended December 31 1989	 1988
	(£ million)	
Net income	452	887
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Depreciation	167	151
Provision for loan losses	1,397	301
Provision for deferred taxes	(206)	56
Gain on realisation of investments	3	(15)
Gain on sale of property and equipment	(40)	(27)
Increase in taxes payable	202	212
Increase in interest and commission receivable	(592)	(242)
Increase in interest and commission payable	733	209
Net increase in sundry debtors and other debit balances	(850)	201
Increase in operating lease receivables	(78)	58
Net increase in accrued expenses and other credit balances	679	557
Increase in net trading assets of securities business	(132)	(196)
Undistributed earnings of associated companies	(41)	36
Total adjustments	1,242	740
Net cash provided by operating activities	1,694	1,627
CASH FLOWS FROM INVESTING ACTIVITIES		
Net increase in lendings to customers and placings with banks	(14,840)	(13,312)
Purchase of assets to be leased	(1,532)	(1,682)
Principal payments received under leases	1,161	906
Capital expenditure	(435)	(295)
Proceeds from sale of property and equipment	116	88
Net decrease in dealing securities	36	202
Net (increase) decrease in non-dealing securities	(118)	420
Net decrease (increase) in certificates of deposit	294	(1,071)
Purchase of trade investments and associated companies	(62)	(27)
Proceeds from disposals of trade investments and associated companies	13	21
Net cash used in investing activities	(15,367)	(14,750)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits and savings accounts	5,826	4,238
Net increase in other time deposits	10,997	8,807
Proceeds from issue of Ordinary Shares	35	943
Increase in minority interests	332	5
Proceeds from issue of long-term borrowings	79	177
Repayment of long-term borrowings	(268)	(73)
Proceeds from issue of loan capital	200	-
Repayment of loan capital	(53)	(141)
Net movement in items in transit	(193)	324
Dividends paid	(273)	(205)
Net cash provided by financing activities	16,682	14,075
Exchange and other adjustments	327	37
Net increase in cash and cash equivalents	3,336	989
Cash and cash equivalents at beginning of year	14,368	13,379
Cash and cash equivalents at end of year	17,704	14,368

EXCHANGE CONTROLS AND OTHER LIMITATIONS AFFECTING SECURITY HOLDERS

There are currently no UK laws, decrees or regulations which would affect the transfer of capital or remittance of dividends, interest and other payments to holders of Barclays securities who are not residents of the United Kingdom. There are no restrictions under the Articles of Association of Barclays PLC or the Bank or under UK law as currently in effect which limit the right of non-resident or foreign owners, as such, freely to hold Barclays securities or, when entitled to vote, freely to vote such securities.

TRADING MARKET FOR SHARES

Trading Market for Ordinary Shares of Barclays PLC

The nominal capital of Barclays PLC is divided into 1,499,000,000 Ordinary Shares of £1 each ("Ordinary Shares") and 1,000,000 Staff Shares of £1 each ("Staff Shares"). At the close of business on December 31, 1989 1,123,232,848 £1 Ordinary Shares and 875,000 Staff Shares were outstanding.

The principal trading market for Barclays PLC shares is The International Stock Exchange, London. Ordinary Share listings were also obtained on the Tokyo Stock Exchange with effect from August 1, 1986 and the New York Stock Exchange ("NYSE") with effect from September 9, 1986.

Trading on the NYSE is in the form of American Depositary Shares ("ADSs") under the symbol "BCS". Each ADS represents four £1 Ordinary Shares and is evidenced by an American Depositary Receipt ("ADR"). The ADR depositary is Morgan Guaranty Trust Company of New York. Details of trading activity are published in the stock tables of leading daily newspapers in the United States.

There were 418 recorded holders of Ordinary Shares, including those holding ADRs, with US addresses at December 31, 1989, whose shareholdings represented approximately 1.01% of total outstanding Ordinary Shares on that date.

The following tables set forth the high and low sales prices for the £1 Ordinary Shares during the periods indicated based on mid-market prices at close of business on The International Stock Exchange and the high and low sales prices for ADSs as reported on the NYSE composite tape.

	£1 Ordinary Shares		American Depositary Shares	
	High	Low	High	Low
	(Sterling:pence)		(US dollars)	
1989				
Fourth quarter	571	448	37	28¼
Third quarter	556	448	35½	28¼
Second quarter	484	426	31⅜	26⅜
First quarter	484	402	33⅜	29
1988				
Fourth quarter	429	401	31	28
Third quarter	420	391	29½	26⅜
Second quarter	481	378	31¼	27½
First quarter	523	459	32⅛	27⅝

Comparison of share prices is influenced by the rights issue in May 1988.

Trading Market for Preference Shares of Barclays Bank PLC

At December 31, 1989, Barclays Bank PLC had outstanding 20,000,000 Non-cumulative Dollar-denominated Preference Shares, all issued in 1989, with a nominal value of $0.01 each. The only trading market for these shares is the New York Stock Exchange where they are traded in the form of ADSs, each ADS representing one Preference Share and being evidenced by an ADR. The ADR depositary is Morgan Guaranty Trust Company of New York.

At December 31, 1989, the Series A Preference Share ADRs were held by 2,476 recorded holders, and the Series B Preference Share ADRs by 927 recorded holders, all with US addresses.

The following table sets forth the high and low sales prices for the Series A and Series B Preference Share ADSs during the periods indicated, as reported on the NYSE composite tape.

	American Depositary Shares			
	Series A		Series B	
	High	Low	High	Low
	(US dollars)		(US dollars)	
1989				
Fourth quarter	25¼	24	24⅞	24
Third quarter	26⅛	24	-	-

The Series A Preference Share ADSs were issued during the second quarter of 1989 and the Series B Preference Share ADSs were issued during the third quarter.

DIVIDENDS

Dividends on the Ordinary Shares of Barclays PLC

Barclays PLC has paid dividends on its Ordinary Shares every year without interruption since its incorporation in 1896.

The following table sets out dividends declared for each of the last five years, adjusted where appropriate to take account of the rights issue made in 1988.

	1989	1988	1987	1986	1985
Pence per £1 Ordinary Share					
First interim	11.40	10.00	9.01	8.15	7.21
Second interim	16.00	13.00	10.93	9.86	8.75
	27.40	23.00	19.94	18.01	15.96
Dollars per £1 Ordinary Share					
First interim	0.18	0.17	0.14	0.12	0.10
Second interim	0.27	0.22	0.21	0.16	0.13
	0.45	0.39	0.35	0.28	0.23

The following table sets out gross dividends applicable to an ADS representing four Ordinary Shares, before deduction of withholding tax, but including the UK imputed tax credit (see "Taxation"). Barclays PLC ADSs were first issued in September 1986. Figures for dividends per ADS are shown below for five years to illustrate the position had ADSs been issued and outstanding throughout the period.

	1989	1988	1987	1986	1985
Dollars per ADS					
First interim	0.94	0.92	0.81	0.65	0.58
Second interim	1.45	1.19	1.10	0.87	0.72
	2.39	2.11	1.91	1.52	1.30

Dividends expressed in dollars are translated from sterling at the noon buying rates for cable transfers in New York City for the days on which dividends were paid, except for the 1989 second interim dividend, payable on May 10, 1990, which is translated to dollars using the noon buying rate applicable on February 20, 1990, the latest practical date for inclusion in this report. No representation is made that pounds sterling amounts have been, or could have been, or could be, converted into dollars at these rates.

At the 1989 Annual General Meeting, shareholders authorised the Directors to introduce a scheme offering shareholders the option to elect to receive new Ordinary Shares in lieu of cash dividends. It is proposed that the authority to Directors be renewed for a further year at the 1990 Annual General Meeting, to be held on April 26, 1990. This election will not be made available to shareholders in the United States and Canada (including holders of Barclays American Depositary Receipts).

Dividends on the Preference Shares of Barclays Bank PLC

Dividends on the Preference Shares are at such a rate as will, before deduction of UK withholding tax but including the UK associated tax credit (see "Taxation"), result in the dividend to holders of Series A Preference Shares being 11.120%, and the dividend to holders of Series B Preference Shares being 10.875%, of the liquidation value of the Preference Shares ($25 per share).

TAXATION

The following is a summary of the principal US federal and UK tax consequences for holders of Ordinary Shares of Barclays PLC, Preference Shares of the Bank, ADRs representing such Ordinary Shares or Preference Shares and loan stock guaranteed by the Bank, who are citizens or residents of the United States or otherwise subject to US federal income tax on a net income basis in respect of such securities and who have no connection with the United Kingdom other than the holding of the shares, ADRs or loan stock in question ("US Holders"). It is not a comprehensive analysis of all the potential tax consequences for such holders. Investors are advised to consult their tax advisers on the tax consequences of their holdings, including the consequences under applicable state and local law.

The statements of tax laws set out below are based on the laws in force as at the date of this report and are subject to any subsequent changes in UK or US law or in any double taxation convention between the United States and the United Kingdom.

For purposes of the current US-UK double taxation conventions relating to income and estate and gift taxes and for the purposes of the US Internal Revenue Code of 1986, as amended ("the Code"), the holders of ADRs are treated as owners of the underlying Ordinary Shares or Preference Shares, as the case may be.

Taxation of Dividends

In accordance with UK law, Barclays PLC and the Bank pay dividends in respect of their Ordinary Shares and Preference Shares without any deduction or withholding in respect of any taxes imposed by the UK Government or any UK taxing authority. However, following payment of a dividend, account must be made to the Commissioners of Inland Revenue for advance corporation tax ("ACT") which is currently equal to 25/75ths of the dividend paid. The rate of advance corporation tax is linked to the basic rate of income tax which is subject to review in the annual Budget in March.

Under the Income Tax Convention between the United States and the United Kingdom, the tax treatment depends on the status of the shareholder. A US Holder who is a US resident individual or a US corporation (other than a corporation which controls, directly or indirectly, 10% or more of the voting shares of Barclays) and whose holding is not effectively connected with (a) in the case of a corporation, a permanent establishment in the United Kingdom through which the holder carries on business therein, or (b) in the case of an individual, a fixed base regularly available and situated in the United Kingdom from which the holder performs independent personal services, will be entitled to a repayment from the UK Inland Revenue of the tax credit to which a UK resident individual would have been entitled in respect of such dividend less an amount equal to 15% of the sum of the dividend and the tax credit. Thus, assuming continuance of ACT at the rate of 25/75ths, payment to such a US Holder of a dividend of £75 would result in a tax credit repayment of £25 less a UK withholding tax of £15 giving a total net receipt of £85. As used herein, the term "US corporation" means any corporation (or any unincorporated entity treated as a corporation for US tax purposes) organised under the laws of the United States or any state or the District of Columbia.

Arrangements have been made with the UK Inland Revenue so that, subject to certain exclusions referred to below, the tax credit will be paid net of UK withholding tax at the same time as, and together with, any dividend paid by Barclays PLC or the Bank to a US Holder of an ADR in respect of the related dividend. The manner in which such refund is obtained will depend on whether the US Holder holds the ADR directly, in which case the holder must complete a declaration on the back of the dividend cheque and present the cheque for payment within three months of its date of issue, or through an account held by an agent, dealer or broker with The Depository Trust Company, in which case a similar declaration must be made by the agent, dealer or broker. Certain categories of US Holders may be excluded from the foregoing arrangements, including, among others, persons exempt from US federal tax, owners of 10% or more of the Ordinary Shares or Preference Shares, estates or trusts having beneficiaries who are not US residents, and certain investment and holding companies. US Holders of ADRs who do not satisfy the relevant requirements must, in order to obtain a refund of tax credit (net of UK withholding tax), file, in the manner and at the time specified by procedures established by the UK Inland Revenue, a claim for refund of tax credit identifying the dividends with respect to which the tax credit was paid.

Taxation (continued)

The gross dividend (the sum of the dividend paid plus any related UK ACT refund and any withholding tax thereon) paid to a US Holder will be included in gross income and treated as foreign source dividend income for US federal income tax purposes to the extent paid out of current or accumulated earnings and profits, as determined under current US federal income tax principles. Such dividends generally will not be eligible for the "dividends received" deduction allowed to US corporations under the Code. Subject to certain limitations on foreign tax credits, the applicable UK withholding tax will be treated as a foreign tax eligible for credit against such holders' US federal income taxes. In the case of the Ordinary Shares, special rules apply for purposes of determining the dividend paid, foreign tax credit and the "dividends received" deduction available to a US corporation which controls 10% or more of the voting shares and value of Barclays PLC.

Legislation exists in the United Kingdom which, if brought into effect, could withdraw the entitlement of a US corporation to the tax credit repayments described above if it, or an associated company (as defined in the legislation), has a qualifying presence in a state which utilises a world-wide unitary combination method of tax accounting. The legislation would apply only to US corporate holders owning, directly or indirectly, 10% or more of the voting shares of Barclays PLC. The likelihood of this legislation being brought into effect, its precise form or its effective date cannot be predicted.

Holders of Ordinary Shares, Preference Shares or ADRs who reside in countries other than the United States or the United Kingdom are advised to seek professional advice as to whether any repayment of ACT will be available to them, and as to their tax liability in their country of residence on income from such Ordinary Shares, Preference Shares or ADRs.

Taxation of Capital Gains

US Holders of Ordinary Shares, Preference Shares or ADRs who are not resident or, in the case of an individual, ordinarily resident, in the United Kingdom, will not be subject to UK taxation of capital gains realised on the disposal of their Ordinary Shares, Preference Shares or ADRs unless such securities are used or held for the purposes of a trade carried on in the United Kingdom through a branch or agency.

A US Holder of Ordinary Shares, Preference Shares or ADRs or, under certain circumstances, an alien individual physically present in the United States for a period or periods aggregating 183 days or more during the taxable year, will be taxable under the laws of the United States on any gains recognised on the disposition of his Ordinary Shares, Preference Shares or ADRs. The amount of the gain or loss will be equal to the difference between the amount realised and the holder's tax basis in the Ordinary Share, Preference Share or ADR, and will generally be capital gain or loss if such security was a capital asset in the hands of the holder. Capital gains are currently taxed at the same rates as ordinary income. The deductibility of capital losses is subject to limitations. Subject to certain limitations on foreign tax credits, US Holders who are liable for both US and UK tax on gains on the disposal of Ordinary Shares, Preference Shares or ADRs will generally be entitled to a tax credit against their US federal tax liability for the amount of the UK tax paid in respect of such gain.

Taxation of Redemption Premium

In the event that the Bank redeems a Preference Share, any excess paid by the Bank over the amount originally subscribed for such Preference Share (the "premium") will be treated for UK tax purposes in broadly the same manner as a dividend paid by the Bank. Accordingly, as described under "Taxation of Dividends" above, the Bank will normally be required to account for ACT in respect of the premium. US Holders eligible for relief under the US-UK Income Tax Convention may, in certain circumstances, be entitled to a refund equal to the ACT paid in respect of the premium, less UK withholding tax, as described under "Taxation of Dividends" above.

A redemption by the Bank of a Preference Share will constitute a taxable transaction on which a US Holder of such Preference Share (or ADR in respect of such Preference Share) will generally recognise capital gain or loss (assuming that the Preference Share or ADR is held as a capital asset and further assuming that such holder does not own, and is not deemed to own, any Ordinary Shares of the Bank). The amount of the gain or loss will be equal to the difference between (i) the total redemption price (including amounts in respect of any related refund of ACT and the amount of any applicable UK withholding tax thereon, but excluding any amounts treated as dividends for US federal income tax purposes) and (ii) the tax basis of the Preference Share or ADR surrendered. The applicable UK withholding tax on the redemption of a Preference Share may be claimed as a credit against the US federal income tax liability of a US Holder, subject to the applicable foreign tax credit limitations and elections, as appropriate. US Holders are advised to consult their own tax advisers as to the US federal income tax consequences of a redemption of Preference Shares.

Stamp Duty

No stamp duty is payable on the transfer of an ADR, provided that the separate instrument of transfer is not executed in, and remains at all times outside, the United Kingdom.

Backup Withholding

A US holder of Ordinary Shares, Preference Shares or ADRs may be subject to US backup withholding at the rate of 20% in respect of dividends paid on, or the proceeds of a sale, exchange or redemption of such securities unless such holder (a) is a corporation, or comes within certain other exempt categories and, when required, demonstrates this fact, or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules.

Estate and Gift Tax

The current Estate and Gift Tax Convention (the "Convention") between the United States and the United Kingdom generally relieves from the UK inheritance tax (the equivalent of US federal estate and gift tax) the transfer of Ordinary Shares, Preference Shares or ADRs where the individual US holder making the transfer is domiciled for the purposes of the Convention in the United States and is not a national of the United Kingdom. This will not apply if the Ordinary Shares, Preference Shares or ADRs are part of the business property of an individual's permanent establishment in the United Kingdom or are related to the fixed base in the United Kingdom of a person providing independent personal services. If no relief is given under the Convention, UK inheritance tax may be charged on the amount by which the value of the individual's estate is reduced as a result of any transfer by way of gift or other gratuitous transaction made by him or treated as made by him, on or within seven years of his death. In the unusual case where Ordinary Shares, Preference Shares or ADRs are subject to both UK inheritance tax and US federal estate or gift tax, the Convention generally provides for tax paid in the United Kingdom to be credited against tax payable in the United States or for tax paid in the United States to be credited against tax payable in the United Kingdom based on priority rules set forth in the Convention.

Payments under Loan Stock Guarantees

On the basis of the practice followed by the UK Inland Revenue authorities at the date hereof, the Bank would not be required to deduct or withhold any taxes or other charges imposed by the United Kingdom from any payment due or to become due to residents of the United States in respect of guarantees given by the Bank in relation to the long-term debt issues made by Barclays North American Capital Corporation.

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorised.

BARCLAYS PLC

Registrant

By BRIAN GERALD PEARSE Finance Director

(Brian Gerald Pearse)

Date: March 1, 1990

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorised.

BARCLAYS BANK PLC

Registrant

By BRIAN GERALD PEARSE Finance Director

(Brian Gerald Pearse)

Date: March 1, 1990

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* Not applicable

The **Chairman**. Well, thank you very much for such a thoughtful and wide-ranging summary and for the backup paper that you have given us.

Let me before proceeding to our next witness, let me call on Senator D'Amato for any opening comment he wishes to make.

Senator **D'Amato**. Thank you, Mr. Chairman.

Mr. Chairman, I found Mr. Leslie's presentation very thought provoking, particularly that aspect that touched on the extreme differences as it relates to our public protection under FDIC. I think it's something certainly we should look into in terms of a modification of the system that we now have. It may force some more prudence, et cetera, but it's extremely interesting.

I want to commend you, Mr. Chairman, for calling these hearings.

The **Chairman**. Thank you very much, Senator D'Amato.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

I do not have a formal opening statement, but I wish to thank you and the panelists this morning for what I'm certain is going to be a very stimulating discussion.

Our country comes out of a long tradition of parochialism in which we saw the world as essentially being the continent that we occupied. Now we are on a quick pace to try to better understand the rest of the world and specifically its financial systems and what position we will have within that rest of the world. I consider ourselves fortunate to have such excellent professors this morning.

Thank you.

The **Chairman**. Thank you, Senator Graham.

Senator Dixon.

Senator **Dixon**. Mr. Chairman, I have a statement which I have just handed to one of the staff, and I would appreciate it if it could be reproduced in the record.

The **Chairman**. Without objection.

Senator **Dixon**. And I thank you for this hearing.

Good morning, gentlemen.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. President, I am pleased to be here this morning on this first day of hearings on financial services developments and trends in Europe and Japan. We have a very distinguished group of witnesses before us today, and I look forward to hearing their testimony.

I hope all of our witnesses can comment on the way their national safety nets—their deposit insurance and regulatory systems—work in practice. I know, for example, that deposit insurance systems abroad offer much less explicit protection than the FDIC provides. However, I am also aware that the systems, in practice, seem to provide at least as much protection for uninsured depositors as our system does, and perhaps more.

I am also aware that there seems to be less bank failure abroad and less public cost. I do not raise this point to suggest that we should adopt the European or Japanese systems. The United States system has always been biased in favor of a large, unconcentrated banking sector, and I want to preserve a strong, pro-competitive banking system where banks can know and be close to their local markets.

I also recognize, however, that there is much we can learn from the experience of bankers and bank regulators in Europe and Japan. The world is increasingly interdependent, and our banks face ever-increasing international competition.

Action on comprehensive reform of our banking laws is long overdue. Today's hearing will help us as we seek to put the right kind of reform legislation together.

The CHAIRMAN. Very good.

Next now we are going to hear from the Deutsche Bank, and Mr. Cartellieri, we're very pleased to have you.

I on another occasion have had the opportunity to hear you speak, and I know you will have some important thoughts for us today, and we would like to hear from you now.

STATEMENT OF ULRICH CARTELLIERI, MEMBER, BOARD OF MANAGING DIRECTORS, DEUTSCHE BANK AG, DUESSELDORF, FEDERAL REPUBLIC OF GERMANY

Mr. CARTELLIERI. Thank you, Mr. Chairman.

I am Ulrich Cartellieri, a Member of the Board of Managing Directors of Deutsche Bank in Frankfurt, Germany.

It is an honor for me to appear before this distinguished committee and to contribute to your deliberations on the future structure of the United States financial industry.

Mr. Chairman, let me address the first question in your invitation letter by briefly describing the German banking structure:

Ninety-five percent of the about 4,300 financial institutions in my country are full-service banks. We call them "universal banks." Among these, the public-sector banks have 50 percent, one half of the total market in terms of business volume. The other half is held by the privately owned and the cooperative banks.

Among the 300 private banks, many of whom are owned by large numbers of shareholders—my own bank has about 310,000 shareholders. Among these, about 300 private banks, are the three so-called Grossbanken, the big banks. The largest one of these is my own institution, the Deutsche Bank.

We have a market share of 3.9 percent. Foreign banks maintain over 600 active offices in Germany, and their total market share comes to 4.6 percent. I think these few figures show that the market is rather fragmented. Nationwide competition is vigorous and it is still increasing, also from nonbanks.

Now, how are banks in Germany regulated and supervised? Basically, they are ruled by one Federal law, the Federal Banking Act, and supervised by one authority, the Federal Supervisory Office in Berlin. The Bundesbank, our central bank, takes a supporting role, it supervises adherence to minimum reserve requirements, it observes cross-border flows of funds and monitors closely the performance of the industry.

Contrary to widespread myth, Mr. Chairman, there is nothing special about the German "universal banks." Traditionally, a universal bank as we understand it offers the main financial products both in commercial and in investment banking. Thus, Deutsche Bank, beyond commercial banking, is also active in underwriting, dealing and brokering of debt and equity instruments.

Beyond that, German banks are free to engage directly or indirectly in manifold business activities, including business activities not related to banking. In this context, there is concern sometimes raised in the political arena about equity investments of German banks in non-financial companies. However, we have to be reminded that many of those industrial investments have their origins in rescue operations. For example, that applies also to our own major shareholding in Daimler-Benz which dates back to the 1920's and has an origin of this kind.

Furthermore, in 1989, or the end of last year, the total investments of the 10 largest German private banks in industrial companies amounted to about ½ percent, 0.5 percent, of the aggregate capital of all German companies with equity exceeding DM 1 million.

Now, what are the advantages of universal banking as we see them? The most essential ones we find first in the fact that universal banking permits banks to spread their risks and to operate on the basis of highly diversified balance sheets. They can compensate low profits or losses in one sector with good profits in other sectors. Such spreading of risks leads to an appreciable institutional stability, it reduces the potential for claims on deposit insurance and it stabilizes the financial industry as a whole.

Universal banking also allows our banks to meet the increasingly sophisticated demands of German and international customers. And that we find particularly welcome and necessary when we consider the competitive pressures in our industry.

There is, of course, also a negative side. On this side I would see a tendency in universal banks towards a lower degree of efficiency and excellence compared to a system which features specialized institutions. For good reasons, it is American commercial and American investment banks like Citibank or Morgan Stanley who are among the world leaders in their respective fields.

When we compare and assess the competitive position of these differently regulated and structured financial industries, we see more advantages in a system that allows diversification and a balancing of risks among various sectors of the banking business, over a system that lends itself to more homogeneous competition, and to producing top performers in their sector. Restricting banking activities against market forces, in our view, potentially leads to overproportionate risk accumulation in one field and it is also more prone to result in major accidents for lack of balancing capacity.

Critics of our structure have asserted that German universal banks have, at least in the past, preferred commercial lending to their corporate clients over equity financing via the capital markets. We have never understood this argument. It is as wrong as it sounds, for the marketplace, our competitors and our customers would never have tolerated such practices if they had ever been tried. Clearly, this would be a recipe for self-defeat in a very competitive market.

Mr. Chairman, let me turn to your questions regarding deposit insurance.

Deposit insurance in my country is organized by the three banking sectors autonomously and privately. Membership in the private banks' insurance scheme is voluntary, but practically close to 100 percent. Fees are collected in proportion to deposits. The deposit insurance fund set up by the private banking sector aims at protecting the individual depositor, not the bank. I have to add, however, that we had one case in the early 1980's where a medium-sized private bank was rescued by the fund in consultation with the members. In contrast, the insurance systems maintained by the public sector and the cooperative banks aim directly at keeping their institutions afloat.

This leads us to the question of the "too big to fail doctrine." I think there can be no doubt that the markets consider it a reality. For, there was no major bank in recent years, one can say in recent decades, that has been allowed to fail. Certainly, this has worked to stabilize the international financial system more than once. But it has also eliminated a basic market mechanism to do away with overcapacities. Overcapacities which are, as far as I can see, the core of the problems of our industry and the key reason for undue risk taking in search of profits. There must be doubt whether the risks which banks nowadays take can be reasonably and effectively monitored and limited by the present efforts of national and international regulators.

As far as we can see, these regulatory efforts appear to lack harmonization as well as practicability and they tend to be much too complicated, especially with regard to assessing and restricting off-balance sheet risks.

I would like to submit, Mr. Chairman, that a more market-oriented and, therefore, superior solution could be developed by introducing risk-related deposit insurance premiums based on regular audits and based on ratings of the asset and liability quality of a bank, combined with regular publicity like that exercised regularly by the rating agencies these days.

I have noticed with interest that the Chairman of the Federal Reserve, Mr. Greenspan, according to press reports, has voiced similar considerations quite recently. Such a solution could stem the tide of too excessive and overly sophisticated rules in national and in international banking supervision.

Finally, on your question of the future of the global financial services industry, I share the view of those observers within and outside the industry who expect a major shakeout and rationalization. Already existing overcapacities depress profitability, and increasing operating costs, foremost in the electronic data processing-sector will reinforce this trend.

On the other hand, it is equally true that in the post industrial era, the general trend towards increasingly affluent, consumer-oriented service economies will create a growing potential for new financial services. Many of these will center around personal consumption, investment and advice.

This means that the financial turf will not only considerably expand its size, but it will also become much more contested as newcomers and non-financial companies enter the market—on the national, the international, and even on global levels. As a consequence, the structure of the financial industry is bound to become so heterogeneous that it will render the definition of this industry, as we have known it, increasingly obsolete.

This will make the task of financial regulators even more difficult and complex than it already is, unless we rethink our basic approach and revert to relying on the fundamental principles of self-regulating market forces. In order to function properly and to exercise their disciplining force on all participants, the markets, of course, need full information, and that means transparency.

Consequently, the focus of financial regulation in a fast changing and increasingly diffuse environment would have to be on strict supervision as well as on full visibility and transparency of financial transactions and their underlying risks, but not on restricting these activities, as this would be accomplished by the coercion of market forces alone.

In summary, Mr. Chairman, I think what we need is more professional supervision, less regulation.

Thank you, Mr. Chairman, and distinguished members of this committee for having given me the opportunity to present to you these considerations.

[The complete prepared statement of Ulrich Cartellieri follows:]

June 11, 1990

Statement

by

Dr. Ulrich Cartellieri

Member of the Board of Managing Directors of
DEUTSCHE BANK AG

before the

United States Senate Committee
on Banking, Housing and Urban Affairs

June 13, 1990

I. The structure of the German banking system

In the Federal Republic of Germany there are about 4,300 banks. As used in the following, the term "banks" comprises private, savings and cooperative banks with roughly 40,000 domestic branches. On average, there is one bank branch per 1,400 inhabitants. The Federal Republic therefore has the densest branch network of all major industrial nations.

95% of all German banks are universal banks. 5% are specialized institutions. While a universal bank may quite simply be defined as any bank which offers "the full range of financial services under one roof," a more detailed description is set out in Chapter II below. In terms of the number of banks, 11% belong to the private sector and 14% to the public sector. 75% - by far the majority of banks - are cooperative banks. The relatively small cooperative banks, however, account for only a 20% share in the business volume of all banks. The market share of private banks (including private mortgage banks) amounts to 30%, that of public-sector institutions including savings banks, public mortgage banks, and their central institutions (the so-called Landesbanken) to 50%. Part of the about 300 private banks, many of which are owned by large numbers of shareholders, are the three so-called Großbanken, i.e., Deutsche Bank AG, Dresdner Bank AG, and Commerzbank AG. The largest one is Deutsche Bank with a market share of 3.9%. (For more detailed information on the structure of the German banking system see Annex 1; for a survey of Deutsche Bank Group see Annex 2).

German banks are not subject to any restrictions with regard to their freedom to set up branches and to engage in all kinds of business activities. Although competition is restricted within the cooperative and public-sector banking segments by means of horizontal, i.e. geographical, and vertical limitations, there is unlimited and indeed vigorous competition not only between private banks, cooperative banks, and public-sector institutions, but also between the banks within the private sector itself.

Foreign banks and non-banks, e.g. insurance companies, credit card companies, and trading houses, which are forcing their way into traditional areas of banking activity, are generating additional competitive pressure. Foreign banks have over 600 active offices both on subsidiary and branch levels in Germany. Their market share amounts to 4.6%, although it is larger in terms of trading volumes and other forms of measurement.

The banks are reacting to the growing intensity of competition with a tendency towards specialization on the one hand, which can for example be observed in the portfolio management business, and with a trend towards so-called "Allfinanz" groups on the other. The latter concept adds insurance services, the building loan savings business, management consultancy etc. to the existing range of universal banking services.

II. What activities, investments and affiliations are permissible for banking organizations in Germany and to what extent are these arrangements permitted directly within a bank, through a subsidiary, or through an affiliate?

A. Scope of activities permissible for Universal banks within the same banking entity

The German universal banking concept is reflected in the Banking Act with its broad and comprehensive definition of "banking institution."

Any enterprise engaging to a certain extent directly in any of the activities specified as "banking business" in Sec. 1 of the Banking Act (Gesetz über das Kreditwesen; see Annex 3) is regarded as a bank. Such activities comprise the deposit and the credit business as well as certain security activities including brokering government and corporate debt and equity instruments and the securities custody business. They are thus subject to regulatory and supervisory measures in accordance with the Banking Act and are supervised by the Federal Banking Supervisory Office (Supervisory Office).

In addition to "banking business" as defined in Sec. 1 of the Banking Act, German banks may, within the same entity, engage directly in almost unlimited other activities, which, in practice, often include all kinds of further securities-related business such as underwriting and dealing in government and corporate debt and equity instruments. Thus, the distinction between investment banking and commercial banking is largely unknown to the German banking system. Other activities carried out by German banks include providing investment advice, management consulting services, factoring, leasing, and real estate brokerage and investment. To the extent that banks engage in activities in addition to what is defined as "banking business" in Sec. 1 of the Banking Act, they also fall under the overall supervision of the Supervisory Office.

B. Scope of investments and affiliations permitted to banks in Germany

German banks are free to engage indirectly through subsidiaries in all kinds of business activities - be they of a financial or non-financial nature.

There is a limited number of financial activities which for legal reasons may only be pursued in specialized credit institutions.

These, however, may be - and in fact often are - subsidiaries of universal banks. Such limitations include:

- the investment fund business;
- the issuance of mortgage-backed bonds and municipal bonds backed by loans to municipalities. This business is reserved for mortgage banks (Hypothekenbanken) and ship mortgage banks (Schiffshypothekenbanken), respectively. Their activities are regulated by the Mortgage Bank Act (Hypothekenbankgesetz) and the Ship Mortgage Bank Act (Schiffsbankgesetz);
- transactions of building loan associations, so-called Bausparkassen, which are specialized institutions engaging in the business of (i) accepting deposits from depositors with whom they enter into a contractual savings plan and (ii) extending loans to such depositors with favorable interest rates and secured by mortgages. Such loans can only be used for the acquisition, renovation, and improvement of housing or property development.

Because of regulations governing the insurance sector, banks like any other business, can engage in insurance activities only via specialized subsidiaries. Banks, in fact, increasingly engage in life and other insurance activities. German banks thereby wish to participate in the expanding life insurance market, which is eroding their traditional retail deposit basis by virtue of continuously attracting a bigger share of private household savings. At the same time, by selling life insurance over the counter, the banks try to improve the productivity of their dense domestic branch network.

Furthermore, there are restrictions under the Federal Cartel Act (Gesetz gegen Wettbewerbsbeschränkungen), which subjects mergers and acquisitions of enterprises to wide-ranging anti-monopoly controls. Within the financial sector all institutions are, also with regard to their shareholdings in subsidiaries and their equity investments, subject to supervisory rules regarding their solvency and liquidity and diversification of risks. These supervisory rules include the following:

(i) Under Sec. 12 Banking Act, the aggregate book value of relatively illiquid investments of a bank, e.g. in real estate, buildings, equipment, ships as well as equity investments in banks or other enterprises, provided that these latter investments exceed 10%, may not be higher than the total equity of the bank.

By implementing the EC Second Banking Directive (No. 89/646/EEC), qualified shareholdings of a bank in a non-financial enterprise, i.e. one that exceeds 10%, will be limited to 15% of the bank's equity capital. At the same time, the total amount of qualified shareholding in the non-financial sector may not exceed 60% of the bank's equity capital.

(ii) Rule of adequate capitalization: The aggregate amount of all credits extended and equity investments held by a bank may not exceed 18 times the bank's equity capital (see Principle I of the "Principles Concerning the Equity Capital and Liquidity of Banks" as issued by the Supervisory Office; this rule will be extended to off-balance sheet items as of October 1, 1990). The EC directive on solvency ratios for banks (No. 89/647/EC) establishes a minimum capital/asset ratio of 8% and counts the shareholdings in subsidiaries and equity investments of a bank among the risk-weighted assets.

(iii) In accordance with Sec. 13 and Sec. 19 of the Banking Act, equity investments in a borrower's enterprise are treated as loans for lending limit purposes. They are thus calculated into the "large credit" exposure limit of a bank, which amounts to 50% of the bank's equity capital. Since a group of companies (Konzern) is defined as one single borrower (Sec. 19 of the Banking Act) and since a bank's own group is also considered to be one single borrower, the equity investments of a bank in non-consolidated members of its own group together with the lending exposure to these members are, on the aggregate level, effectively limited to 50% of such bank's equity capital.

The development of universal banks into universal banking groups meets with the expectation of the market that banks stand behind their financial subsidiaries. This is why banks have to be supervised on a consolidated basis, as required by the "Basle Recommendation of Capital Adequacy", the respective EC directives and German regulations. This is also the reason why a number of large German banks have issued letters of comfort explicitly stating that they stand behind their financial subsidiaries.

Many German banks historically have close ties with industrial and commercial companies, which may be reinforced by equity investments in such companies. This fact, along with the presence of representatives of German banks on supervisory boards[1] of industrial and commercial enterprises as well as proxy voting by banks in shareholders' meetings, has been a matter of political debate in the Federal Republic in recent years. The debate revolves around the alleged economic power of the banks. The proxy voting powers of banks, however, are strictly regulated by law. All equity investments of the ten largest private banks in non-financial companies amounted in 1989 to only 0.57 percent of the aggregate nominal capitalization of all German corporations with an equity capital over 1 million DM. That percentage represents an aggregate nominal value of 1.68 billion DM. There were only 101 aggregate nominal capitalization of all German corporations with an equity capital over 1 million DM. That percentage represents an aggregate nominal value of 1.68 billion DM. There were only 101 cases in which such equity investments exceeded 10 percent of the non-banking companies' equity, including 29 cases of shareholdings exceeding 25 percent of such companies' equity. A comparison of the data for 1976 and 1989 shows that the banks have substantially reduced their equity investments in the non-financial sector over the last 12 years.

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[1] German stock corporations have a dual board system: While the managing board is responsible for the overall management of a stock corporation, the supervisory board's function is to control the managing board and to appoint its members.

Last but not least the banks' equity investments in many cases stem from rescue operations. Other equity investments are temporarily acquired for the purpose of future public placements of the shares or for rendering financial assistance to undercapitalized small- or medium-sized corporations. On the other hand, equity investments made by banks in non-financial companies can - and often do - have a stabilizing effect on the banks' earnings over the long term because they make it possible to spread the sources of a bank's earnings and the risks involved in conducting its business.

In recognition of these facts, the public debate has faded, and parliamentary action beyond the forthcoming restrictions laid down in the new EC regulations seems unlikely.

C. Conflicts of Interest

It has been asserted that the relatively low capitalization of German industrial companies - average equity is about 24 percent of their total assets - is due to the fact that the banks have been more interested in extending credits than in underwriting and distributing equities. This argument is as wrong as it sounds, for the market place, the competitors and the customers would never have tolerated such practices - if they had been tried. It would be a recipe for self-defeat. Deutsche Bank, for example, has a record of vigorously promoting the going public of private companies, including smaller ones.

Vigorous and still increasing competition exists not only among banks, but also between banks and other financial institutions such as insurance companies and credit card companies. In such an environment, any inadequate handling of possible conflicts of interest by a bank would jeopardize the reputation of the respective bank. This would inevitably cause a loss of business. It is important, in this connection, to take into account that German banking is largely based on customer relationships, which rely on confidence and confidentiality and are less transaction-oriented. Furthermore, the banks have been under strong public scrutiny over the last decades, by the media in particular and by public opinion in general.

III. How would you compare the bank and financial regulatory and supervisory apparatus in Germany with ours in the United States? In this regard do you think that the manner in which the United States regulates its financial system, in comparison with the way your system is regulated, has a negative impact on the competitiveness of United States financial institutions and markets?

A. The German regulatory and supervisory apparatus

The main supervisory body is the Federal Supervisory Office. The functions of this institution are to safeguard the general banking system, secure the banking industry's ability to function and to avoid undue risks for the creditors of banks (Sec. 6 of the Banking Act). Its goal, in more general terms, is to guarantee the safety and soundness of the banking system. The Supervisory Office reports directly to the Federal Ministry of Finance.

Within the objectives of the Banking Act, the Supervisory Office supervises all activities performed by banks, regardless of whether they are privately owned, savings or cooperative banks. The focus is on compliance with the provisions of the Banking Act as well as with certain other supplementary banking laws applicable to the specialized banks. Public-sector institutions, such as the savings banks, are in addition subject to supplementary state supervision which does, however, not supersede supervision by the Supervisory Office and is mainly a reflection of public-sector ownership.

The Supervisory Office is the licensing agency for all banks and has broad powers in terms of information gathering, investigation, and intervention. It also has significant policy-making powers, for example in determining the principles governing capital and liquidity requirements. Supervision by this authority is mainly quantity-oriented, i.e. it focuses on the overall amounts of risks. It is quality-oriented in the sense of examining the specific individual risks, e.g. with regard to the creditworthiness of the debtor, to the extent that it receives and examines the annual audit reports of the bank's external auditors (certified public accountants). Since 1985, supervision has been undertaken on a consolidated basis comprising any group member that is active in the financial field and in which a bank holds 40% or more of the equity.

The second supervisory body for German banks is the Deutsche Bundesbank (Central Bank) which itself is mainly regulated by the Central Bank Act (Gesetz über die Deutsche Bundesbank).

The primary task of the Bundesbank is to keep the Deutschmark stable. The instruments which allow the Bundesbank to control the circulation and supply of money, and thereby maintain monetary stability, are the discount and lombard rate as well as the open market and minimum reserve policies and, finally, the authority to issue banknotes. These instruments enable the Bundesbank to regulate the financial sector in the interest of monetary stability. They are distinctly different from the prudential supervisory measures of the Supervisory Office. Pursuant to the stipulations of the Banking Act, the Bundesbank is nevertheless also involved in banking supervision in a supporting role and exercises its supervisory functions in this regard in close cooperation with the Supervisory Office (Sec. 7 of the Banking Act).

The Bundesbank's prime task in this context is data collection. It has a network of regional and local offices throughout Germany, and by collecting all the statistical data and most of the reports issued by banks it has extensive knowledge of the financial status of all individual banks and their borrowers. The Bundesbank shares this information promptly with the Supervisory Office, which is responsible for taking any supervisory steps, if necessary. The chart in Annex 4, by the way, offers a survey on the structure of banking supervision in Germany.

In sum, regulation and supervision of banks in Germany is centralized and exercised on a federal, i.e. nation-wide level. This system has proven to be efficient and cost-saving for both the banks and the public. Doubt, however, has been arising as to whether the risks which banks nowadays assume - mainly in the context of operating with new financial instruments like swaps, futures, and options - can be reasonably and effectively monitored and limited by the present efforts of national and international regulators. These regulatory efforts appear to lack harmonization and practicability, and they tend to be too complicated especially with regard to off-balance sheet risks.

B. Impact of the U.S. financial regulatory system on the competitiveness of United States financial institutions and markets

It has been criticized that the spreading of regulatory functions among a broad range of authorities has not helped to strengthen banking supervision.

The Glass-Steagall Act, along with the firewalls and other requirements regarding the "Section 20 Subsidiaries" of U.S. banks, still restricts U.S. banks in comparison to the broad flexibility which universal banks have in coping with new developments and new competitive challenges from within the financial field. But the progressive erosion of the McFadden Act, should on the other hand contribute to a strengthening of U.S. financial institutions because it promotes their regional broadening and thus makes them larger and more stable banks. Such broader-based banks should be better positioned to compete with each other and in the international arena. It is true that the prevailing specialization of U.S. commercial and investment banks has made some of them top performers and world leaders in their sectors. Almost by their very nature, however, do these specialized financial institutions tend to assume greater risks in their pursuit of performance and profit.

Universal banks, by contrast, can operate on the basis of a highly diversified balance sheet. Risk concentration is substantially lower. Lower profits or losses in one sector may be compensated by higher profits in another field. A comparison of earnings trends appears to confirm that the broad range of activities pursued by universal banks not only spreads the risk, but also stabilizes earnings considerably.

Furthermore, the diversification of risks and the relative stability of earnings of universal banks are a key factor in the stability of the entire banking system. Simultaneously, there is a much lower risk of calls on the deposit insurance system.

IV. What are the differences, as you understand them, in our systems of deposit insurance and our attitudes toward financially troubled institutions? For example, what type of safety net does your government or private sector provide for depositors of a failing institution and what are your views regarding a "too big to fail" doctrine?

A. Deposit protection schemes in Germany

There is no statutory deposit insurance in Germany. Each of the three large groups of the German banking industry, i.e., private banks, savings banks, and cooperative banks, has set up its own comprehensive system of deposit protection. While all three protection systems do not grant any right to enforce intervention or payments by the respective fund, the protection systems of the three banking sectors differ considerably with regard to one aspect: The deposit protection scheme of the private banks is geared toward the direct protection of deposits. The public-sector and cooperative banks, on the other hand, have established the principle of assistance to the failing institution.

The private banks consider that deposit protection should not hinder market forces to eliminate weak performers. Nevertheless a precedent has been established in the early 1980s when a medium-sized private bank was rescued by the fund upon consultation with its members. Generally, however, the purpose of the Deposit Protection Fund of the Federal Association of German Banks

(Einlagensicherungsfonds des Bundesverbandes Deutscher Banken e.V., "Fund"), is "to give assistance to depositors in the event of imminent or actual financial difficulties of banks, particularly when the suspension of payments is imminent, and to prevent the impairment of public confidence in private banks." All measures fulfilling that mandate of the Fund are permissible, in particular making payments to individual creditors.

The Fund protects all deposits placed with member banks, by non-banks, be they individuals or corporations, up to a level of 30 percent per depositor of the equity of the respective bank. In practice, therefore, most customer deposits, even at small member banks, are protected for their full amounts. At a bank with the minimum prescribed equity of DM 6 million, customer deposits would be protected up to DM 1.8 million per customer. This applies to all demand, time, and savings deposits by non-banks. Claims on banks arising from, or in connection with, securities issued or sold by banks are however not protected.

In case of a bank failure securities held by banks in safe custody are protected by way of separation from the bank's assets under the respective Act and therefore do not need to be included in the banks' protection scheme.

Membership in the Fund is voluntary and open to all privately owned banks operating in Germany, including the branches of foreign banks. In practice, all banks which belong to member associations of the Federal Association of German Banks are participating in the Fund. The scheme is a joint and voluntary undertaking of the private banks based on their own responsibility and solidarity. In order to qualify for membership, a bank must fulfill certain requirements, such as maintain minimum equity capital and adequate liquidity in conformance with the requirements of the Supervisory Office, employ at least two qualified managers, and it must be a member of the Auditing Association of German Banks.

The Fund collects premiums from the member banks, usually in the amount of 0.03 percent annually of the total non-bank deposits. These premiums may be doubled or extraordinary premiums may be called for as needed. No public support is granted.

The Fund is administered by the Federal Association of German Private Banks. Investment of the Fund's assets is made in accordance with special guidelines established by a Fund Committee formed within the Association.

All member banks are subject to regular or special audits by the Auditing Association of German Banks in order to allow them to recognize unfavorable developments in a banks's business in time and thereby avoid or reduce losses for the fund. The results of such audits are reported to the Supervisory Office which takes action if necessary.

Since the inception of the Fund in 1976, it has protected deposits in 18 cases and effectively prevented any losses for depositors.

B. The Liquiditäts-Konsortialbank (Liko-Bank)

This bank was established as a consequence of the failure of a large private bank (the Herstatt Bank) in 1974. Its task is to secure the liquidity of financially sound institutions, which run into temporary liquidity difficulties, so that the functioning of domestic and foreign payment and clearing transactions by banks is ensured.

The bank operates as a limited liability company. 30% of its shares are held by the Bundesbank. The rest is held by institutions from all sectors of the banking industry: 32.5% by the private banks, 26.5% by the public sector banks, and 11% by the cooperative banks.

The Liko-Bank may grant loans to institutions encountering liquidity problems, deposit money with them and buy bills from them. Bills of exchange drawn on, and accepted by, the Liko-Bank can be rediscounted with the Bundesbank under a special rediscount facility. The Liko-Bank may also operate other businesses to the extent that they serve the purpose of achieving its main objective of securing the liquidity of financial institutions which are held to be solvent but temporarily illiquid.

C. The Bundesbank as "lender of last resort"

The provision of liquidity to banks by the Bundesbank takes place through (i) the rediscount of eligible paper with the Bundesbank within the limits set by rediscount quotas for each bank individually, and (ii) through extending loans secured by eligible instruments under the "Lombard facilities."

Pursuant to the Central Bank Act, the Bundesbank may provide liquidity to an individual bank to the extent that such bank has eligible paper at its disposal. Additional liquidity can be made available through the above-mentioned Liko-Bank if the difficulties of the respective bank are only temporary and if the bank is still solvent.

The policy of the Bundesbank as lender of last resort has been influenced by the Herstatt case in 1974. At the time, several banks had to be given liquidity assistance on an ad-hoc basis. Subsequently, the Central Bank Governors of the Group of Ten countries addressed the problem of lender of last resort on a wider scale when they dealt with the Euro-markets in the so-called Basle

Convention. They agreed that it would not be practical to lay down in advance any detailed rules and procedures for the provision of temporary liquidity, but that sufficient means would be available in case of need.

D. The "too big to fail" doctrine

This leads to the "too big to fail" doctrine. This doctrine has proved its merits more than once in upholding a smooth functioning of the international banking system. But it certainly is correct to say that it has also eliminated a basic market mechanism to do away with the overcapacities we are confronted with in banking on an international scale. The cause of these overcapacities, as far as commercial banking is concerned, may be directly traced to present terms of deposit insurance. Simply stated, the depositor has no reason to care about the quality of the bank with which he deposits his funds. Consequently there are more banks pressed to compete by assuming higher risks in pursuit of performance and profits.

A more market-oriented and therefore superior solution could be found by introducing risk-related deposit insurance premiums based on regular audits and ratings of the asset and liability quality of a bank, combined with regular publicity like that exercised by the rating agencies. Similar considerations which, according to press reports, were recently outlined by Federal Reserve Chairman Greenspan deserve full attention and support. Such a solution could stem the tide of too excessive and overly sophisticated rules in national and international banking supervision.

V. How do you envision the global financial services industry evolving over the next several years and, in view of Europe 1992, what trends and developments do you think the United States Congress and Administration should be most aware of in terms of considering how to modernize our own system? Are the various banking models within the nation states of the European Community likely to converge to one model and, if so, what is that model likely to be?

A. Expected development of the global financial services industry over the next years

A further concentration of the world financial markets of the three "centers of gravity" - the United States, Japan and Europe - can be expected. The U.S. dollar should maintain its dominant role in the world financial system though its relative weight may decrease.

We assume the world-wide trend toward universal banking will continue. The mid-1990s should see the evolution of universal banks in all countries of the "triad."

A key function for regulatory authorities should then be to ensure that no new competitive distortions arise to the detriment of either type of bank, be it specialized or universal. The development of form and structure of the financial institution of the future should be left to the financial institutions and thus to the market.

With regard to existing overcapacities, the increasing operating cost and the investments which are necessary especially in the EDP sector, the number of independent financial institutions can be expected to decrease substantially.

On the other hand, in the post-industrial era, the general trend towards increasingly affluent, consumer-oriented service economies will create a growing potential for new financial services. These will center around personal consumption, investment and advice. The financial turf will, therefore, not only considerably expand its size, but will also become much more contested as more newcomers and non-financial companies enter the market - on the national, the international, and even a global level.

B. Trends and developments in view of Europe 1992

1. Once the single EC financial market is completed, it will be the largest and most liberal financial market in the world. Three direct effects can be expected from this:

   a) Competition will intensify.
   b) The innovation process will concentrate on new products, new organizational forms, and new distribution channels; the search for loopholes in the regulatory system will lose importance.
   c) Europe will become even more attractive for banks from non-EC countries because of the far-reaching business opportunities there.

2. For the banks, "Europe 1992" symbolizes a monetary unification process which is to be developed through the following stages:

   a) A uniform financial market without internal borders: All capital controls must be dismantled by the middle of this year. France complied with this mandate in January 1990, Italy in May 1990. For Spain, Portugal, Ireland and Greece there are transitional periods up to 1992 and 1995.
   b) A single banking market without regulatory borders: In the future, financial institutions will be able to operate on

an EC-wide level under the same conditions. A bank license from one EC member state will entitle an institution to operate either on a cross-border basis or by establishing its own branch network throughout the EC. Regulation and supervision will be carried out by the licensing country and will be recognized in all other EC states.

c) A single currency zone with a Euro-Fed and a European currency: Later this year, an inter-governmental conference is to work on amendments to the Treaty of Rome necessary to establish a European Monetary Union. These modifications should be ratified by the end of 1992 by the national parliaments. While this does not suggest that a Euro-Fed will be established by 1993, the European Monetary Union might be effective by the mid-90's.

3. The mutual recognition of banking licenses and supervisory measures in the individual EC states presupposes a minimum of common standards. Consensus has developed on the definition of equity capital and a solvability coefficient, a ratio of equity capital and a bank's risk business volume. There is also consensus on the necessity of exposure limits for large-scale loans and of setting up deposit insurance in all EC member countries. All risk-limiting regulations relate to the entire range of services offered by a universal bank. While less stringent provisions are planned for investment banks, universal banks are expected to be free to apply these lesser standards to their own investment banking business as well.

4. Foreign banks will be subject to the same conditions of admission in the single European market and will have the same business opportunities as institutions domiciled in the EC. This principle of national treatment is, however, conditional on EC banks not being discriminated against in the respective non-EC countries.

C. Future development of the various banking models

Europe will have a single financial market, but no uniform banking system. There are, however, clear signs of convergence in the field of banking regulation. In the single market, with its harmonized regulation, its freedom to establish branches and no administrative firewalls between different banking sectors, there will be ample space for various forms of financial institutions to compete, including universal and specialized banks. Under these competitive pressures, we expect a growing number of institutions to take their business in new directions both in financial and non-financial areas. Only a limited number of institutions, however, will have the skills and financial strength needed for operating on a Europe-wide scale. More institutions will therefore concentrate on specific business sectors, customer groups, or regions.

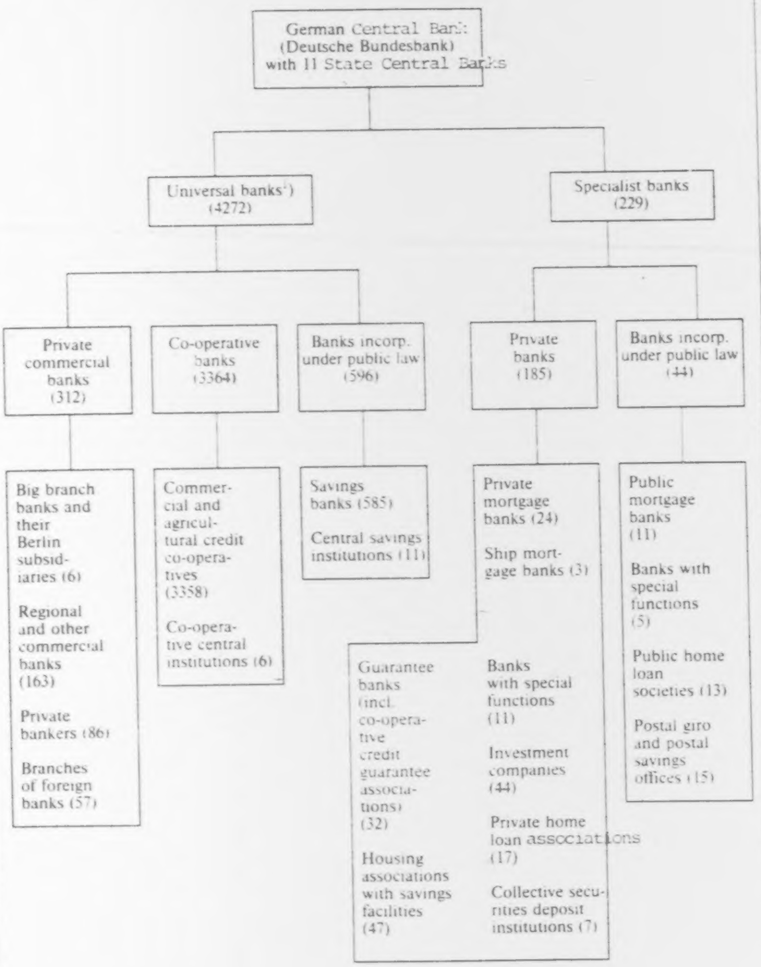
While it is difficult to predict the future structure of the financial industry in Europe, we consider it fair to assume that with respect to even more transgressing competitors both from within and from outside the established financial sector, lines of defintion will be blurred to the extent as to render the term "financial industry" obsolete. Manufacturers (e.g. the automobile industry), retailers, transportation businesses, insurers, EDP network operators of various kinds, and other companies will increasingly provide financial services. Financial institutions, for their part, will answer this competitive threat by engaging themselves in these businesses as well as in other non-financial businesses.

D. Consequences for financial regulation

The task of financial regulators will therefore become even more difficult and complex than it already is - unless they rethink their basic approach and revert to relying on the fundamental principles of self-regulating market forces. In order to function properly and to exercise their disciplinary force on all participants, the markets need full information, i.e. transparency. Consequently, the focus of financial regulation in a fast changing and increasingly diffuse environment would have to be on strict supervision as well as on full visibility and transparency of financial transactions and their underlying risks - not on restricting these activities, as this would be accomplished by the coercion of market forces alone.

ANNEX I

The Banking System in the Federal Republic of Germany
(Number of institutions as at the end of 1988)


German Central Bank
(Deutsche Bundesbank)
with 11 State Central Banks
Universal banks¹)
(4272)
Specialist banks
(229)
Private commercial banks
(312)
Co-operative banks
(3364)
Banks incorp. under public law
(596)
Private banks
(185)
Banks incorp. under public law
(44)
Big branch banks and their Berlin subsidiaries (6)
Regional and other commercial banks (163)
Private bankers (86)
Branches of foreign banks (57)
Commercial and agricultural credit co-operatives (3358)
Co-operative central institutions (6)
Savings banks (585)
Central savings institutions (11)
Private mortgage banks (24)
Ship mortgage banks (3)
Guarantee banks (incl. co-operative credit guarantee associations) (32)
Housing associations with savings facilities (47)
Banks with special functions (11)
Investment companies (44)
Private home loan associations (17)
Collective securities deposit institutions (7)
Public mortgage banks (11)
Banks with special functions (5)
Public home loan societies (13)
Postal giro and postal savings offices (15)

¹) Also called full-service or all-round banks

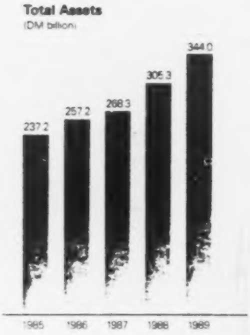
Source: Bundesverband deutscher Banken e.V., Cologne 1989

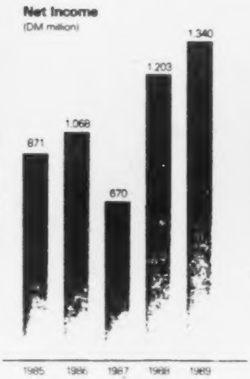
Annex II

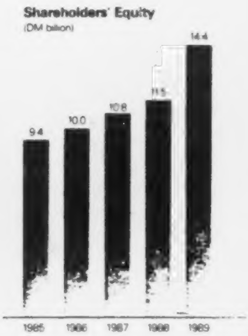
Deutsche Bank at a glance – 1989

Deutsche Bank Group

Net income *(million)*	DM	1,340
Shareholders' equity *(million)*	DM	14,367
Total assets *(million)*	DM	343,984
Shareholders' equity as % of year-end total assets		4.2 %
Return on average shareholders' equity		10.3 %
Net income per share	DM	33.10
Cash dividend *(Deutsche Bank AG)*	DM	14.00
Domestic branches and subsidiaries		1,330
International branches and subsidiaries		310
Employees worldwide		56,580
Customers worldwide *(million)*		6.98







Deutsche Bank

The services of Deutsche Bank Group are provided in particular by the following companies throughout the world

German

Commercial banks

Deutsche Bank AG
Frankfurt am Main
Capital and reserves DM 14 667 m *

Deutsche Bank Berlin AG
Berlin
Capital and reserves DM 720.6 m Holding 100%

Deutsche Bank Lübeck AG vormals Handelsbank
Lübeck
Capital and reserves DM 122.1 m Holding 91.5%

Deutsche Bank Saar AG
Saarbrücken
Capital and reserves DM 91.6 m Holding 69.2%

Mortgage banks

Deutsche Centralbodenkredit-AG
Berlin – Cologne
Capital and reserves DM 786.5 m Holding 91.0%

Frankfurter Hypothekenbank AG
Frankfurt am Main
Capital and reserves DM 811.8 m Holding 93.1%

Lübecker Hypothekenbank AG
Lübeck
Capital and reserves DM 254.2 m Holding 100%

Schiffshypothekenbank zu Lübeck AG
Hamburg
Capital and reserves DM 86.9 m Holding 100%

Investment banking, capital market and capital investment companies

DB Capital Management International GmbH
Frankfurt am Main
Capital and reserves DM 8.2 m Holding 100%

degab Deutsche Gesellschaft für Anlageberatung mbH
Frankfurt am Main
Capital and reserves DM 0.7 m Holding 100%

Deutsche Gesellschaft für Fondsverwaltung mbH
Frankfurt am Main
Capital and reserves DM 38.6 m Holding 100%

DWS Deutsche Gesellschaft für Wertpapiersparen mbH
Frankfurt am Main
Capital and reserves DM 143.0 m Holding 93%

Deutsche Grundbesitz-Investmentgesellschaft mbH
Frankfurt am Main
Capital and reserves DM 23.4 m Holding 60%

Deutsche Vermögensbildungsgesellschaft mbH
Bad Homburg v d H
Capital and reserves DM 5.4 m Holding 100%

Grunelius KG Privatbankiers
Frankfurt am Main
Capital and reserves DM 33.7 m Holding over 80%

International

Banca d'America e d'Italia S.p.A.
Milan
Capital and reserves Lit 529.0 bn Holding 98.6%

Banco Comercial Transatlántico, S.A.
Barcelona
Capital and reserves Ptas 18.9 bn Holding 72.1%

Banco de Montevideo
Montevideo
Capital and reserves U N$ 12.6 bn Holding 95.4%

H. Albert de Bary & Co. N.V.
Amsterdam
Capital and reserves Gul 180.3 m Holding 100%

Deutsche Bank Australia Ltd
Melbourne
Capital and reserves A$ 132.2 m Holding 100%

Deutsche Bank (Austria) AG
Vienna
Capital and reserves AS 85.3 m Holding 100%

Deutsche Bank (Canada)
Toronto
Capital and reserves Can $ 71.4 m Holding 100%

Deutsche Bank Luxembourg S.A.
Luxembourg
Capital and reserves LF 16.1 bn Holding 100%

DB Asia Finance (HK) Ltd
Hong Kong
Capital and reserves US$ 6.6 m Holding 100%

DB (Belgium) Finance S.A./N.V.
Brussels
Capital and reserves BF 262.3 m Holding 100%

DB U.K. Finance p.l.c.
London
Capital and reserves £ 21.0 m Holding 100%

Europäische Hypothekenbank der Deutschen Bank
Luxembourg
Capital and reserves DM 29.9 m Holding 100%

Bain & Company Ltd
Sydney
Capital and reserves A$ 34.8 m Holding 50%

Deutsche Bank Capital Corporation
New York
Capital and reserves US$ 102.3 m Holding 100%

Deutsche Bank Capital Markets Ltd
London
Capital and reserves £ 37.1 m Holding 100%

Deutsche Bank Government Securities, Inc.
New York
Capital and reserves US$ 48.5 m Holding 100%

Deutsche Bank (Suisse) S.A.
Geneva
Capital and reserves SF 119.7 m Holding 100%

DB Capital Markets (Asia) Ltd
Hong Kong
Capital and reserves US$ 13.0 m Holding 80%

Internationale Investment Management Gesellschaft S.A.
Luxembourg
Capital and reserves DM 73.6 m Holding 100%

McLean McCarthy Ltd
Toronto
Capital and reserves Can $ 4.1 m Holdi

MDM Sociedade de Investimento, S.A
Lisbon
Capital and reserves Esc 1.7 bn Holdi

Morgan Grenfell Group plc
London
Capital and reserves £ 353.6 m Holdi

Instalment financing and leasing companies

ALD AutoLeasing D GmbH
Hamburg
Capital and reserves DM 71.1 m Holding 51%

ComCo Datenanlagen GmbH & Co. KG
Korntal-Münchingen
Capital and reserves DM 5.0 m Holding 81%

DB Export-Leasing GmbH
Frankfurt am Main
Capital and reserves DM 0.05 m Holding 100%

Deutsche Immobilien Leasing GmbH
Düsseldorf
Capital and reserves DM 38.3 m Holding 50%

EFGEE Gesellschaft für Einkaufs-Finanzierung mbH
Düsseldorf
Capital and reserves DM 18.0 m Holding 100%

GEFA Gesellschaft für Absatzfinanzierung mbH
Wuppertal
Capital and reserves DM 153.0 m Holding 100%

GEFA-Leasing GmbH
Wuppertal
Capital and reserves DM 56.0 m Holding 100%

BAI Factoring S.p.A.
Milan
Capital and reserves Lit 5.3 bn Holding 100%

BAI Leasing S.p.A.
Milan
Capital and reserves Lit 6.9 bn Holding 100%

Deutsche Credit Corporation
Deerfield (U.S.A.)
Capital and reserves US$ 18.3 m Holding 100%

Leasing Bancotrans, S.A.
Barcelona
Capital and reserves Ptas 395.8 m Holding 100%

P.T. Euras Buana Leasing Indonesia
Jakarta
Capital and reserves Rp 3.8 bn Holding 60%

Specialized institutions

Deutsche Bank Bauspar-AG
Frankfurt am Main
Capital and reserves DM 26.8 m Holding 99%

Deutsche Beteiligungsgesellschaft mbH
Frankfurt am Main
Capital and reserves DM 3.8 m Holding 92.5%

Lebensversicherungs-AG der Deutschen Bank
Wiesbaden
Capital and reserves DM 53.2 m Holding 100%

Consultancy companies

Roland Berger & Partner Holding GmbH
Munich
Capital and reserves DM 20.1 m Holding 75.1%

DB Mergers & Acquisitions GmbH
Frankfurt am Main
Capital and reserves DM 15.8 m Holding 100%

Deutsche Gesellschaft für Mittelstandsberatung mbH
Munich
Capital and reserves DM 2.6 m Holding 100%

Deutsche Grundbesitz-Anlagegesellschaft mbH
Frankfurt am Main
Capital and reserves DM 3.5 m Holding 60%

DPE Deutsche Projektentwicklungs-Gesellschaft für Grundvermögen mbH
Frankfurt am Main
Capital and reserves DM 1.3 m Holding 50%

Immobiliengesellschaft der Deutschen Bank mbH
Frankfurt am Main
Capital and reserves DM 6.0 m Holding 100%

Vestbel & Partners Ltd.
Tokyo
Capital and reserves Yen 83.9 m Holding 33.3%

International financing companies

Deutsche Bank Finance N.V.
Curaçao
Capital and reserves US$ 5.4 m Holding 100%

Deutsche Bank Financial Inc.
Dover (U.S.A.)
Capital and reserves US$ 0.08 m Holding 100%

Deutsche Finance (Netherlands) B.V.
Amsterdam
Capital and reserves Gui 10.2 m Holding 100%

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* incl. capital increase in February 1990 and exchange of bonds from the 4% convertible bond issue up to end of February 1990

Annex III

The full catalogue of banking activities under **Sec. 1 Banking Act** ("Gesetz über das Kreditwesen") is as follows:

(i) "The acceptance of monies from others as deposits, irrespective of whether interest is paid thereon (deposit business; Einlagengeschäft)."

(ii) "The granting of loans and acceptance of credits (credit business; Kreditgeschäft).

(iii) "The purchase of bills of exchange, promissory notes and cheques (discount business; Diskontgeschäft).

(iv) "The purchase and sale of securities for the account of others (security business; Effektengeschäft)," i.e. security brokering.

(v) "The custody and administration of securities for the account of others (custody business; Depotgeschäft)."

(vi) "The transactions designated in Sec. 1 of the Investment Companies Act (mutual investment fund business; Investmentgeschäft)." These may only be carried out by investment fund companies that are specialized institutions engaged only in the setting-up and administration of mutual investment funds.

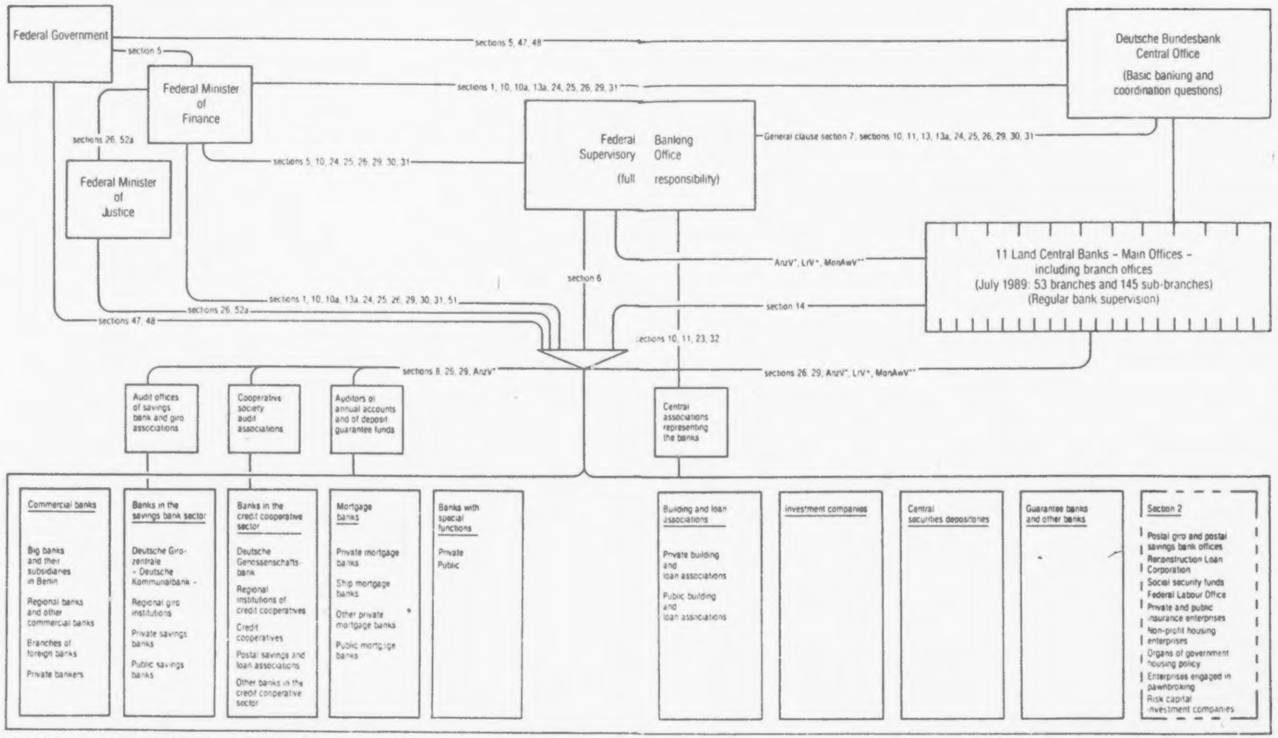
(vii) "The incurring of the obligation to acquire claims in respect to loans prior to their maturity."

(viii) "The assumption for others of guarantees and other indemnities (guarantee business; Garantiegeschäft)."

(ix) "The effecting of cashless transfers and clearings (giro business; Girogeschäft)."

ANNEX IV

Bank supervision in the Federal Republic of Germany


Federal Government
section 5
sections 5, 47, 48
Deutsche Bundesbank Central Office (Basic banking and coordination questions)
Federal Minister of Finance
sections 1, 10, 10a, 13a, 24, 25, 26, 29, 31
sections 26, 52a
Federal Minister of Justice
sections 5, 10, 24, 25, 26, 29, 30, 31
Federal Supervisory Banking Office (full responsibility)
General clause section 7; sections 10, 11, 13, 13a, 24, 25, 26, 29, 30, 31
11 Land Central Banks – Main Offices – including branch offices (July 1989: 53 branches and 145 sub-branches) (Regular bank supervision)
AnzV*, LrV*, MonAwV**
section 6
section 14
sections 1, 10, 10a, 13a, 24, 25, 26, 29, 30, 31, 51
sections 26, 52a
sections 47, 48
sections 10, 11, 23, 32
sections 8, 26, 29, AnzV*
sections 26, 29, AnzV*, LrV*, MonAwV**
Audit offices of savings bank and giro associations
Cooperative society audit associations
Auditors of annual accounts and of deposit guarantee funds
Central associations representing the banks
Commercial banks
Big banks and their subsidiaries in Berlin
Regional banks and other commercial banks
Branches of foreign banks
Private bankers
Banks in the savings bank sector
Deutsche Girozentrale – Deutsche Kommunalbank –
Regional giro institutions
Private savings banks
Public savings banks
Banks in the credit cooperative sector
Deutsche Genossenschaftsbank
Regional institutions of credit cooperatives
Credit cooperatives
Postal savings and loan associations
Other banks in the credit cooperative sector
Mortgage banks
Private mortgage banks
Ship mortgage banks
Other private mortgage banks
Public mortgage banks
Banks with special functions
Private
Public
Building and loan associations
Private building and loan associations
Public building and loan associations
Investment companies
Central securities depositories
Guarantee banks and other banks
Section 2
Postal giro and postal savings bank offices
Reconstruction Loan Corporation
Social security funds
Federal Labour Office
Private and public insurance enterprises
Non-profit housing enterprises
Organs of government housing policy
Enterprises engaged in pawnbroking
Risk capital investment companies

* Reports Ordinance   * Country Exposure Ordinance   ** Monthly Returns Ordinance

Source: Deutsche Bundesbank

The **Chairman**. Thank you, Mr. Cartellieri.

I must say that the last point you make is the most interesting one where the nature of the situation may overwhelm the regulatory process, and you may actually need to have a market discipline which is tougher and faster, assuming you have information out there and it's accurate and it's timely, and that market forces may well be able in a well structured system to apply a discipline that a regulatory system may not be up to developing and applying. It's a very interesting point that you make.

I want to say before yielding to Senator Heinz for any opening comment he has before going to our next witness that all of us in the United States are following with great interest the enormous change going on in Germany and the reunification effort, and I think it's fair to say that opening up of the Berlin Wall and the developments which have to be so profoundly moving and exciting in your country are equally so here.

There is a great positive feeling about the potentials of getting out of this cold war era and moving on into a kind of new work order where civilized discussion on the whole range of issues such as we are endeavoring to have here today can be the order of the day rather than barbed wire and machine gun towers and all of the tensions and frictions that we have all known here for so many years.

So that feeling is a manifest feeling in this country, and I just want to take a moment to say it to you so that you know that it's something that is alive and real here as well.

Mr. **Cartellieri**. Thank you, Mr. Chairman.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Well, Mr. Chairman, I thank you.

I just ask unanimous consent that my statement be placed in the record at the appropriate point.

I would like to join you in welcoming this distinguished panel of bankers from Japan, Germany and the United Kingdom.

I don't know if Senator Dodd was here earlier, but as the Chair well knows, Senator Dodd and I had occasion to visit the European Community about 2 months ago. We met with Members of Parliament from the United Kingdom and the the EC, many of the regulators, members of the commission and other heads of regulatory institutions in Germany and France, the Bundesbank, and a number of bankers and business leaders from the United States who had firms in the EC.

I would just observe that the European Community in particular, and when I visited Japan last year, Japan clearly also are addressing many of the same issues. Japan is addressing Glass-Steagall, the EC is working to flesh out the second banking directive and is trying to deal with the deposit insurance question. I saw a little article in the newspaper this morning about the FDIC and the adequacy of the insurance fund, and it seems we're all focusing very intensely on these questions. Clearly EC-1992 in particular is going to have a major impact on all financial service providers who compete in the international marketplace, and this panel, Mr. Chairman, is very knowledgeable and very well informed.

They are world class competitors, and I think we need to listen to their points of view, and I thank you for having this hearing.

[The opening statement of Senator Heinz to be submitted for the record follows:]

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I commend you for holding today's hearing on international developments in the financial services industry. We are fortunate to have distinguished representatives from among the world's leading financial centers in the United Kingdom, West Germany and Japan. Dramatic events in international capital markets are reshaping the financial services industry around the globe.

I was fortunate to travel to the European Community last March with Senator Dodd to meet with the principal architects of EC-1992, including EC Commissioners responsible for financial services, leaders of the EC Parliament, our counterparts in the British House of Lords and House of Commons, officials of the Bundesbank, Bank of England and other heads of the financial services regulatory agencies in the United Kingdom, Germany and France, as well as business leaders of U.S. firms operating in the EC.

The European Community is addressing many of the same issues that this committee is confronting as we examine the modernization of our financial services industries. EC-1992 will have a major impact on all financial service providers who compete in our international marketplace.

Mr. Chairman, as world class competitors, today's witnesses are in an excellent position to assess the competitiveness of U.S. financial service firms. I look forward to their views and evaluation of our financial services industry.

The CHAIRMAN. Very good. Thank you, Senator Heinz.

STATEMENT OF SENATOR JAKE GARN

Senator GARN. Today the committee turns its attention to the international dimension of the financial modernization issue. We will look at what it will take for America to compete in the international financial marketplace of the 1990's.

It comes as no surprise to anyone who follows these issues that I have long believed that U.S. geographic and product limitations imposed on our financial institutions have to change. Some have argued over the years that the diversity of a system with many thousands of institutions engaged in limited activities is a source of strength for the United States economy. I believe the simple truth of the matter is that real financial strength comes from diversification of risk across geographic and product boundaries.

The debate over whether and how to reform our system has gone on for decades and, given the way Washington works, could go on for decades more. However, we now face pressure for change from beyond the Beltway and beyond our borders. Perhaps the debate will be forced to a sensible conclusion by developments in Europe, Japan, Canada and elsewhere where large, diversified financial service companies are becoming the norm—and capturing the United States market in the process.

I look forward to hearing how banks in these other markets are adapting to a changing world, and the lessons they offer for the United States financial industry of the future.

STATEMENT OF SENATOR TERRY SANFORD

Senator **Sanford**. Thank you, Mr. Chairman, and I would like to thank our extremely distinguished panel of witnesses for traveling a long way and spending a great deal of time to be with us this morning. I also appreciate their very thoughtful and complete testimony.

As we continue our study of reform of our financial services regulations and particularly reform of deposit insurance, I think it is essential that we get a better understanding of how international developments impact our markets. I also think we can benefit tremendously from learning what has worked well in other markets, and what structures have posed problems for some of our competitors.

As we look down the road, it appears clear that the Europeans are continuing to move in the direction of universal banking, with banks permitted to engage in a broad array of both commercial and securities activites. The Japanese, on the other hand, face debates very similar to those taking place here regarding their equivalent of Glass-Steagall, article 65. It looks as if the Japanese have already put in place a process to reach a consensus on those decisions before the 1992 integration of Europe.

I think it is essential, Mr. Chairman, that this committee hear first hand about these international developments and their implications both for our markets and for the United States financial firms competing in Europe and Japan. I also think we stand to benefit from close comparisons of how deposit insurance functions in other markets and the existence or not, whether state or implied, of the equivalent of a "too big to fail" doctrine. I look forward to examination of these and other issues this morning.

Again, I appreciate your efforts in arranging this hearing, and very much look forward to the testimony of our distinguished panel of witnesses.

Before we begin, I have statements from Senators Garn and Sanford to be submitted for the record.

The **Chairman**. Mr. Kusukawa, we are very pleased to have you. We are interested in your comments to us, and we would like to hear from you at this time.

STATEMENT OF TORU KUSUKAWA, DEPUTY PRESIDENT OF THE FUJI BANK, LTD, TOKYO, JAPAN

Mr. **Kusukawa**. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Senate Banking Committee, I am Toru Kusukawa, Deputy President of the Fuji Bank, Limited.

I am pleased to be here today in response to your kind invitation to discuss global trends and developments in financial services. As I do so, please keep in mind that any views I express today are Fuji Bank's or my own, and should not be taken to represent the views of Japanese banks in general.

Also, because English is not my native language, I request both the committee's indulgence and an opportunity to correct any inadvertent misstatement I might make today.

Japan's financial system is basically similar to that of the United States in the sense that one of its key features is compartmentalization. Commercial banking activities have been separated from securities and insurance activities.

Japan and the United States are today the only two major countries to separate by law commercial banking from corporate securities activities. Despite the important similarities there are some critical differences.

For example, there are no geographic restrictions corresponding to the restrictions on interstate banking in the United States. In addition, the total number of banks in Japan, some 150 institutions, is smaller by far than the number of commercial banks in the United States.

In our country, the Ministry of Finance or "MOF" is the primary regulatory authority for banks, securities firms and insurance companies. There is no significant local or "dual" regulation of the financial service industries.

Japan, like the United States, maintains a deposit insurance system. However, no funds have ever actually been withdrawn from the insurance fund because not one bank has failed since the end of the World War II.

In most cases, a bank whose business performance deteriorates is rescued before it goes bankrupt by mutual aid from, or merger with, other banks. A well-functioning, early alert supervisory system in Japan has made this possible.

Detailed inspections by the authorities generally find any deterioration in business performance at an early stage.

Financial disintermediation, securitization, and internationalization trends have recently led our authorities to undertake several important changes in our financial system. First, interest rates on deposits are being deregulated.

In March 1990, 67 percent of Fuji Bank's deposits had unregulated interest rates, up from merely 14 percent in 1986. This has resulted in a rapid increase in the cost of funds for the bank.

Second, we are now in the middle of a serious discussion concerning fundamental reform of our financial system. We expect that a basic consensus will be reached this month on allowing banks and securities companies to engage in each other's business.

However, the necessary legislation will most likely not be drafted and implemented until 1992.

Third, such deregulatory initiatives inevitably require the review of risk management, which helps to explain moves toward new regulation, including, most significantly, the introduction of the BIS international risk-based capital adequacy guidelines.

The deregulation of interest rates and the BIS guidelines together are forcing banks to shift their business focus from "on-balance sheet" asset size to profitability with emphasis on fee-earnings and "off-balance sheet" transactions. This process was begun by U.S. banks some 10 years ago.

As far as I know, there are no clearly established definitions or universally accepted measurements of bank competitiveness. I suppose that competitiveness is generally determined by the quality and price of the services offered and that it might be evaluated more specifically based on a range of different key measurements.

I believe that gauging a bank's competitiveness solely or even primarily on the basis of asset size is misleading. Additional and perhaps better measures of competitiveness include high quality in the broader range of modern bank services not measured "on balance sheet," innovative capability, other criteria of financial strength such as return on equity, return on assets, and capital ratios, and the ability to meet the competition in serving the full range of needs of corporate and individual customers.

Competitiveness of a nation's banking industry overall has two different aspects. First, there is relative competitiveness of the banking industry vis-a-vis other financial institutions domestically.

Both Japanese and United States banks are experiencing a relative decline in competitiveness on this ground. Banks have been challenged by securities firms, insurance companies and other nonbank institutions while new powers enabling banks to respond to this competition, such as broad securities powers, have not yet been forthcoming in either Japan or the United States.

The second aspect is global competitiveness. A bank's competitiveness internationally is largely influenced by the overall economic performance of its home country.

The bank's cost of capital will generally be lower when the domestic investment-savings balance tips in favor of savings. Japanese banks have been benefitting from good economic performance and the relatively high savings rate.

The structure of a bank's home country financial system is also an important factor affecting a bank's international competitiveness. Banks from countries whose financial systems allow a broader range of services at attractive prices will be most competitive.

In this sense, the trend in EC countries towards a universal banking system is very important to Japanese banks. At least theoretically, financial globalization allows customers to seek the best services and conduct transactions with any bank in the world.

We at Fuji Bank believe that, from the viewpoint of services available, universal banks are the most competitive. If Japan maintains its functionally fragmented financial system, our banks will find competing with universal European banks increasingly difficult.

You asked what trends and developments the United States should be aware of modernizing your banking system. In that connection, I would call your attention again to the importance of macroeconomic factors, such as the cost of capital, and the need to improve the investment-savings balance.

While I realize other questions are involved and are really difficult to resolve, nevertheless, reducing the budget deficit and increasing personal savings rates would have major beneficial effects and would be a big step to improving the competitive performance of U.S. banks.

With respect to reform of the financial system, I would like to point to three factors we think are of importance. First, we are advocating the reform of article 65 in Japan.

Second, our banks, unlike those in the United States, can conduct their business nationwide. This allows banks to cover capital flows fully throughout the nation and to diversify their asset portfolios.

Third, we have been successful so far in detecting deterioration in bank performance at an early stage and taking action to deal with the situation.

To conclude, in these times of financial globalization, the financial system of any major country can no longer be independent from the world economy. The most critical issue facing major industrial nations at present is the question of how to reconcile financial globalization with efforts to create the most desirable financial system for each individual nation.

Japan, the United States and Europe must join forces in the construction of efficient, stable and sound financial systems for the coming new century. Convergence of regulatory measures among the major industrial nations is an element of this process, but it should be clearly understood that all of our efforts should permit free market principles to function properly.

Thank you, Mr. Chairman.

[The complete prepared statement of Toru Kusukawa follows:]

Statement of

Toru Kusukawa
Deputy President
The Fuji Bank, Limited

Before the
United States Senate
Committee on Banking, Housing & Urban Affairs

Hearings on
Financial Services Modernization

June 13, 1990

Introduction

Mr. Chairman and members of the Committee, my name is Toru Kusukawa and I am a Deputy President of The Fuji Bank, Limited. I am pleased to be here today at your kind invitation to discuss with you the questions facing the financial services industries of the United States and Japan. Please note that any opinions I express today are Fuji Bank's or my own, and should in no way be construed as representing the views of Japanese banks in general.

You have asked me to comment on (i) the activities permitted to banks in Japan as compared to the United States, (ii) the bank and financial regulatory and supervisory system in Japan as compared to the United States, and whether the United States system negatively affects the competitiveness of United States financial institutions and markets, (iii) the deposit insurance and safety net policies of Japan as compared to the United States, and (iv) trends in the global financial services industry over the next several years, including in particular, Europe 1992.

Let me first introduce the Fuji Bank. Our bank is 110 years old and is one of the leading commercial banks in Japan as well as the world. Fuji Bank has $390 billion in assets, which is fourth among the world's largest banks. The Bank's head office is in Tokyo and we have 274 branches in Japan and 16 in foreign countries. In the United States, we have six branches and agencies, three major operating subsidiaries and two representative offices.

Fuji Bank commends the Committee for examining the issue of financial services modernization in the United States in a broader, global context rather than with a purely domestic focus. Given the extent of globalization of the world financial markets, this is certainly a most appropriate and relevant context.

The Japanese and United States bank regulatory systems have important similarities and differences. Banks in both countries labor under a number of outdated regulations that hamper the competitiveness of the banks of each country. While Japanese banks are often considered highly competitive because of their large asset size, true competitiveness cannot be gauged by this measure alone. Additional and perhaps better measures of competitiveness include (i) high quality in the broader range of modern bank services not measured on balance sheets, (ii) innovative capability, (iii) other criteria of financial strength such as return on equity, return on assets, and capital ratios, and (iv) the ability to meet the competition in serving the full range of needs of corporate and individual customers in the modern marketplace.

Broad trends are fundamentally changing the business of banking and related financial services all around the world, thoroughly revising the requirements for competitiveness of financial institutions and markets. We believe that the universal banking model adopted by the European Community ("EC") is well suited to these modern marketplace developments. EC banks will consequently provide a powerful competitive challenge in world markets in 1992 and beyond. We believe Japan must make changes to accommodate modern developments and there may be implications for the United States as well.

This testimony will address your questions in detail as follows. Part I will describe the Japanese banking and financial system, including a comparison between Japan and the United States in regard to permitted bank activities, the regulatory and supervisory systems, and deposit insurance and safety net policies. Part II will describe recent developments in the Japanese financial environment. Part III will discuss the issue of bank competitiveness, and analyze trends in the competitiveness of financial institutions and markets in Japan and the United States in the context of the modern marketplace. This Part will also discuss our view of the optimal regulatory reforms to respond to modern developments.

I. THE FINANCIAL SYSTEMS OF THE UNITED STATES AND JAPAN

A. Overview

Japan's present financial system was created after World War II, and the fundamental framework has remained unchanged for some forty years. Japan's financial system is basically similar to that of the United States in the sense that one of its key features is compartmentalization.

Japan's financial system is characterized first by the separation of the banking and securities businesses. Figure 1 in the Appendix shows the types and number of financial institutions that operate in Japan. As you know, Article 65 of Japan's Securities and Exchange Law of 1948 is similar to the United States' Glass-Steagall Act, and generally forbids banks from underwriting corporate securities. After recent financial reforms in Canada, Japan and the United States are today the only two major nations that continue by law to separate the banking and corporate securities businesses. Second, the insurance business in Japan is also separated from the banking and securities businesses.

Having said this, I would now like to move on to a discussion of some of the differences. First, Japanese city banks have established nationwide branch networks because of the absence of restrictions corresponding to the regulations on interstate banking established by the McFadden Act, the Bank Holding Company Act and various state laws in the United States.

Second, Japan is unique in that banks are divided into three categories: ordinary banks, trust banks and long-term credit banks (refer to Appendix Figure 1 for more detail). Only trust banks may engage in the trust business. Foreign banks operating in Japan are categorized as ordinary banks; however, unlike Japanese ordinary banks they are permitted to have trust bank subsidiaries. Long-term credit banks are permitted to issue long-term debentures -- a power denied to ordinary banks. Created at the time of the shortage of corporate funds after World War II, this system was designed to ensure the efficient distribution of funds by assigning short-term financing to ordinary banks and long-term financing to trust and long-term credit banks. Today, however, trust banks and long-term credit banks do not enjoy sufficient demand for long-term financing, which used to come from corporate customers. Consequently, they are engaging more and more in short-term financing. Ordinary banks, on the other hand, are increasing the amount of long-term loans mainly in the field of mortgages and real estate related projects. But they are still prohibited from having access to long-term funding, such as long-term debentures and time deposits maturing in more than three years. Facing a mismatch problem of funding and lending, ordinary banks are calling strongly for a repeal of the separation of short-term and long-term finance.

The third respect in which Japan is unique is its Postal Savings System, which is a part of the Ministry of Posts and Telecommunications. This system functions as a giant savings institution with 133 trillion yen (around $927 billion1/, as of December 1989) in deposits. The original objectives of the system, which has now been in place for over 100 years, were to encourage and mobilize savings as a means of accumulating capital on a national basis and to collect small deposits from as broad a base as possible in order to supplement the capital needed for national purposes in the pre-war period. We believe that these goals no longer exist and therefore a thorough review of the system should be made.

Another distinguishing feature of the Japanese system compared to the U.S. system is the difference in the number of banks in the two countries. Recently, 66 out of 68 of Japan's sogo (mutual) banks were converted into ordinary banks, bringing the total number of banks to 152. Nevertheless, this is much smaller than the approximately 13,000 banks in the United States.

Nearly 2,000 banks existed in Japan 90 years ago. But as a result of the various financial crises that have taken place over the years, including the Great Depression beginning in 1929, weak banks either defaulted or were incorporated through mergers into a smaller number of banks. If Japan had geographic restrictions on bank expansion similar to those in the United States, these

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1/ $1.00 = Yen 143.40 (as of December 28, 1989). This calculation is for reference only.

rescues would have been more difficult to achieve because bank failures occurred in all regions of the country. Indeed, the first half of Fuji Bank's 110-year history was one long, continuous story of mergers.

Japan's anti-trust law does not allow the establishment of bank holding companies. Ownership of bank stocks in Japan for the most part is widely dispersed similar to the ownership of large U.S. bank holding companies. In addition, no particular segment of commerce or industry is predominant in its ownership or control of bank shares.

B. Scope of Business Activity

Japan's Banking Law regulates the business activities of ordinary banks and, like U.S. banking laws, defines banks as institutions which engage in (i) both deposit-taking and lending or (ii) settlement of payments. Apart from these traditional activities, ordinary banks are able to engage in foreign exchange and derivative products such as futures and options and the following business activities.

1. Securities Business

Bank involvement in the securities business is restricted by Article 65, which basically forbids banks from underwriting or dealing in corporate bonds and equities. However, banks in Japan are allowed to underwrite and deal in government and municipal bonds, as well as commercial paper. In Japan, commercial paper is not regarded as a security but as a bill discounted. As a result of compromise, both banks and securities firms can handle commercial paper.

2. Other Businesses

Bank affiliates can provide investment management, credit cards, leasing, factoring, data processing, management consulting, and other services closely related to banking. The limitations that apply in Japan on these activities are similar to those under Regulation Y in the United States.

3. Expansion of Overseas Business

Basically, in a foreign country, Japanese banks are able to engage in the same kind of banking and securities activities as the banks and their subsidiaries of the country in question, but only after obtaining approval from the Ministry of Finance ("MOF"). MOF restricts somewhat the overseas activities of banks to reflect the fragmented domestic system. For example, Japanese banks may not engage in insurance activities even if they are permitted for banks in the host country. Regulation K similarly restricts the types of activities in which U.S. banking organizations may engage overseas. The Fuji Bank, like many U.S. banks, has a securities subsidiary in London and universal bank subsidiaries in Frankfurt and Zurich.

C. Regulatory and Administrative Framework

1. Basic Concept of Administration

The first Article of the Japanese Banking Law states that:

> Recognizing the public nature of banking business, this Law aims to maintain orderly credit, to ensure the sound and appropriate management of banking business with a view to ensuring the protection of depositors and facilitating financial transactions, and to contribute thereby to the sound development of the national economy. In implementing this Law, due consideration shall be given to respect each bank's own initiative with respect to the management of banking business.

The first part of this Article describes the importance of the public nature of banking. The latter part, which was added with the strong urging of the banking industry at the time the legislation was considered in 1980, respects the autonomy of banks as private enterprises. Consequently, we can define the goals of bank administration as the maintenance of the proper respect for both the public nature of the business and the autonomy of each individual bank, and the promotion of harmony between these two considerations.

To promote harmony between these two considerations is easy to say, but difficult to achieve. Especially in a country like Japan, where the people, politicians, and journalists expect banks to be impeccably perfect in performing public duties, the public nature often supersedes the consideration of the entrepreneurial spirit of a bank. Because of this tendency, banks need to emphasize on many occasions the necessity of allowing free market principles to function. The intensity of bank supervision in Japan should be understood with this background.

2. The Ministry of Finance ("MOF")

The Japanese administrative system for financial institutions is simpler than the corresponding system in the United States. MOF is the primary regulatory institution for banks. The Banking Bureau of MOF is responsible for approving the business operations and mergers of banks as well as the opening of new bank branches. It also possesses the authority to make inspections, suspend business, and revoke licenses. The Banking

Bureau is also responsible for the supervision of insurance institutions. MOF's Securities Bureau is responsible for the activities of securities firms. The International Finance Bureau of MOF is responsible for the overseas activities of all Japanese financial institutions. I sometimes wish that these functions were all in a single bureau because it would help in simplifying the issues.

The relation between MOF and the banks is basically a cordial one. Because it endeavors to be neutral and fair, MOF often works to create compromise. As one would expect, each type of bank has its own vested interests. These interests are often presented to the Ministry. The formation of policies by MOF, in cases in which interests are diverse, tends to be deliberative and methodical. This serves as a source of irritation for banks.

3. The Bank of Japan ("BOJ")

As the nation's central bank, the Bank of Japan, or BOJ, has four functions: first, it acts as the lender of last resort; second, it maintains the settlement system (each bank has a current account with BOJ for settlement of interbank transactions); third, it conducts monetary policy; and fourth, it supervises the activities of financial institutions that maintain current accounts with it to ensure the efficient and proper operation of bank management. Supervision by BOJ is a condition of maintaining an account with it.

4. Others

There are some financial institutions which do not come under the supervision of either MOF or BOJ, but are subject to the control of other Ministries and local authorities. They are the Postal Savings System, credit cooperatives and agriculture and fishery cooperatives (refer to Appendix Figure 1).

D. The Deposit Insurance System

Japan's deposit insurance system was inaugurated in 1971 with the establishment of The Deposit Insurance Corporation (Special Company) under the provisions of the Deposit Insurance Law. See Appendix Table 1 for a comparison with the U.S. system. The system insures deposits up to ten million yen, roughly $70,000, per person, with a premium of 0.012%. The deposit insurance funds total approximately 440 billion yen ($3.1 billion). The system, however, has never had to withdraw any of its funds. Indeed, Japanese banks never display "Insured Deposit" signs on their premises in order to entice depositors and just a few depositors know that the system exists. Why is this?

Since the end of World War II, not one Japanese bank has gone bankrupt. Only a small number of banks have experienced serious business difficulties, and these were not major banks but small- and medium-sized financial institutions. I would like now to look at some of the reasons why there have been so few bank failures in Japan.

1. The Safety Net in Japan and the United States, and Differences in Supervisory Administration

In Japan, it is critical to bank management to maintain the creditworthiness and credibility of, and public confidence in, the banking system. A bank whose business performance deteriorates is generally rescued by mutual aid from, or merger with, one or more private sector financial institutions. To avoid market disruption and uneasiness, one or more healthy banks will take the initiative to make a special loan to a deteriorating bank or, if necessary, arrange a merger. Such action is routinely accompanied by encouragement and moral suasion by either MOF or BOJ. After such a rescue, the management of the deteriorating institution is expected to step down and will be subject to criminal prosecutions if grave irregularities are involved.

Also important, the authorities responsible for supervision -- MOF and BOJ -- conduct detailed inspections which enable them to detect any deterioration in asset quality and business performance at an early stage and provide the guidance necessary for improving management before the bank deteriorates too far. Moreover, MOF has only a small number of banks to track compared with 13,000 in the United States. In contrast, it is fair to say that the U.S. deposit insurance system was designed to promote confidence in the system by preventing bank runs and as a last resort to deal with bank failures after their occurrence.

You have asked for our views concerning the "too big to fail" doctrine. The nature of the safety net and the system of regulation in Japan has generally limited our need to face the issue of whether this is an appropriate policy. In 1965, Yamaichi Securities, a large securities firm, confronted severe problems as a result of a market crisis. It appears that the repercussions at that time of allowing Yamaichi to fail would have been too great for the system, and thus, the authorities resolved the problem by arranging for indirect loans from BOJ.

Even though this is an example of a rescue of a securities firm rather than a bank, from the administrative side, there seems to be a policy that some financial firms may be "too big to fail." Moreover, there may be a presumption in Japan that the authorities will mobilize to rescue a large entity that is in trouble. However, as a market participant, we do not look to the government as our guardian. We operate on the basis that we are responsible for our actions and will accept the consequences of any deficiency in our performance.

2. Differences in Attitudes Toward Credit Loss in Japan and the United States

Unlike U.S. banks, Japanese banks do not consider credit losses to be part of their necessary costs, and adhere to a policy of strictly avoiding any such losses, however small. Traditionally, the ratio of bad loans to total assets has been very low in Japan. This has something to do with the impeccable perfectionism that I mentioned earlier. However, I do not wish to leave the impression that Japanese banks are not without problems. Like U.S. banks, we have LDC loans, HLT financings, and, from time to time, deterioration in credit quality of certain industries (for example, shipbuilding).

3. Diversification of Assets

Because Japanese banks may establish branches on a nationwide basis, they have been able to diversify their loan portfolios across regions and industrial sectors. In contrast, U.S. banks are inhibited in expanding their business activities nationally, which constrains the creation of an optimal portfolio.

II. RECENT CHANGE OF JAPANESE FINANCIAL ENVIRONMENT

A. Background

In the mid-1970's, the Japanese economy experienced a significant transition from the rapid growth of the preceding decade or so to a period of lower growth. This, in turn, brought about a major change in money flow as the shortage of funds that had affected the corporate sector shifted to the public sector. The primary and secondary government bond markets began to develop as the public sector increased borrowing to cover rising deficits.

Individuals, meanwhile, began to accumulate assets, giving rise to growing demand for diversified asset management techniques. At the same time, the corporate sector began to seek more efficient methods of funding and investment management. Together, these factors led to financial disintermediation. In addition, we see increased economic and financial internationalization, along with the development of computer and communications technology, which have helped to create new financial products (for example, securitized and hybrid products).

In response to these changes, the government has been deregulating interest rates. At the same time, difficulties in introducing various new financial products which fall outside the framework established by the existing fragmented system have led to the initiation of an overall review of the system itself. On the other hand, deregulation inevitably increased the importance of risk management, resulting in a movement toward new regulation, through such measures as the introduction of the Bank for International Settlements ("BIS") international risk-based capital adequacy guidelines.

B. Deregulation of Deposit Interest Rates

Deregulation of deposit interest rates in Japan began with the creation of CDs in 1979, and gained momentum in 1980 when the Foreign Exchange Law was amended to allow free international fund flows. As a result, domestic interest rates were no longer independent of the global financial markets. Furthermore, the roundtable talks between Japan and the United States, known as the Yen-Dollar Committee and the associated working group have contributed to this deregulation.

Money market certificates ("MMCs") and large time deposits with no interest rate ceilings were introduced in 1985. Since then, deregulation has accelerated. The minimum amount of deposit for large time deposit accounts was reduced from the 1985 level of one billion yen, or approximately $7 million, to the current ten million yen, or approximately $70,000. Similar reductions were made in the minimum amount of deposit for MMC accounts, from the initial fifty million yen, or approximately $349,000, to one million yen, or approximately $7,000. (See Appendix Table 2.) This trend is expected to continue.

As a result of this rapid deregulation, Japanese banks, especially the major banks, are experiencing a sharp rise in the ratio of non-regulated interest rate deposits-to-all domestic deposits. For example, Fuji Bank's ratio of non-regulated interest rate deposits in March 1986 was 14%. The ratio jumped to 24% in 1987, 42% in 1988, 54% in 1989 and 67% in March 1990. (In April 1990, the ratio of nonregulated deposits was 70%.) This ratio is comparable with that of U.S. money center banks (approximately 70%) and is expected to continue growing.

While the deregulation of deposit interest rates is broadly supported by consumers, it poses a tremendous challenge for bank management. As of June 8, 1990, the regulated interest rate on (one year) time deposits was 5.63%. In contrast, the interest rate for large (one year) time deposits stood at 7.0%, resulting in a considerable rise in funding costs for banks.

The deregulation of interest rates on deposits in Japan has followed basically the same process as in the United States. Deregulation of interest rates on deposits began in the United States in the early 1970's, and with the further impetus of the Depository Institutions Deregulation and Monetary Control Act of 1980, was completed in 1986. Deregulation in both Japan and the United States has occurred in stages. The only difference between the two countries is timing.

The purpose of the deregulation, of course, is to benefit depositors. We at Fuji Bank support the recent deregulation for this reason. However, the deregulation of deposit interest rates has a greater impact on smaller institutions (such as credit, agriculture and fishery cooperatives) than on larger ones, because smaller ones have less opportunity and less capability to diversify their assets for higher returns. If such an impact is expected to be disproportionately large, something should be done to ameliorate it. A phased-in approach may be one answer.

C. Introduction of BIS Capital Adequacy Guidelines

The BIS risk-based capital adequacy guidelines, which were introduced by all of the world's major countries in 1987, have had a significant impact on bank management in Japan. Due to the deregulation of interest rates, Japanese banks found the asset growth strategy emphasized in the past to be neither interesting nor profitable. With increased risk of fluctuating interest rates and fund availability risk, accompanied by inevitable mismatch problems, a drastic change of management style was needed. Therefore, Japanese banks positively saw the need to introduce the BIS guidelines. This has naturally given them the incentive to encourage capital formation and to improve returns on assets. Japanese banks are now facing the same kind of management challenges U.S. banks faced with deregulation of interest rates.

There are two methods for raising the capital ratio: increasing the numerator -- capital, or decreasing the denominator -- assets. The Japanese economy has in recent years performed well, and the stock market has been buoyant. Consequently, many banks have been able to increase the numerator by raising capital from the market. However, the stock market is currently adjusting to the increase in interest rates and the recent fluctuation in the value of the yen. Because of this, continuing to increase capital at the same pace will be extremely difficult. As a result, Japanese banks are being forced to slow their asset growth in order to achieve a better capital ratio. To help this situation, Japanese banks have been allowed since March of this year to sell their domestic loans, and a secondary market in loans is now forming.

The deregulation of deposit interest rates and the introduction of BIS capital adequacy guidelines are completely changing the strategy of Japanese bank management, causing a drastic and rapid shift away from the traditional emphasis on "quantity" to a new emphasis on profitability, as measured by return on assets and equity. Deregulation started earlier in the United States, and, as you know, U.S. banks have been striving to increase earnings and improve their returns on assets by slowing the growth of their "on-balance sheet" assets, and by engaging in fee-based businesses and "off-balance sheet" transactions such as swaps and options. Japanese banks are now being forced to adopt similar measures.

D. Trends Toward Reform in Financial Systems

Amidst such extensive changes in the financial environment, as long as the present fragmented system continues to restrict the scope of products and services that financial institutions may offer, it will be hard for financial institutions to meet customers' needs and adapt to the changes that have taken place internationally.

For this reason, in 1985, the Financial System Research Council (the "FSRC"), an advisory body to the Minister of Finance, began a study on the form which Japan's financial markets should take in the future. The FSRC released an interim report in 1989. The report advocates reforms which basically would allow banks and securities companies to engage in business in each other's sectors. It also lists five possible approaches to reforming the financial system (see Methods A through E in Appendix Figure 2) and recommends that from the perspectives of efficiency, internationalization, stability and fairness, the most realistic of these are Method B, separate subsidiaries for each business sector, and Method C, multi-functional subsidiaries.

Method A is a so-called piecemeal approach that would take a long time to implement. Method D is difficult because Japanese anti-trust laws prohibit establishment of bank holding companies. Finally, Method E, the option of German-style universal banking offers the advantages of the greatest international competitiveness, efficiency, opportunities to reduce risk through diversification, and convenience to the consumer, as well as maximizing competition within the financial services industry. The report says, however, this option poses concerns about conflicts of interest, economic concentration, and the dislocation that might occur under such a drastic change from our current highly segmented system.

In order to achieve a complete overhaul of the financial system, we must examine not just the financial markets but the capital markets as well. Another advisory body of the Minister of Finance, the Securities Exchange Council, has since 1989 been examining the question of what sort of capital market would best suit Japan. Its deliberations have included consideration of what types of financial institutions should be allowed to engage in various activities in the capital markets, reviewing and analyzing in particular the proposals of the FSRC on this issue.[2]

The Securities Exchange Council is due to release an interim report sometime this month. It is expected to advocate reforms aimed in principle at allowing banks and securities companies to engage in each other's business, and to propose that further studies be conducted to determine the actual structure of these reforms and the way in which firewalls should be treated. Assuming that the removal of restrictions on banks engaging in the securities business and on securities companies engaging in banking is approved, it is generally believed that the necessary legislation will be drawn up before the end of 1992 following further study.

III. BANK COMPETITIVENESS

A. Basic Concepts

1. Definitions and Measurement

I would like next to give you some personal views on the question of bank competitiveness. Competitiveness encompasses a broad range of meaning, and people have varied perceptions. As far as I know, however, there are no clearly established definitions or measurements. Very broadly, I suppose it could be said that competitiveness is generally determined by the quality and price of the services provided.

Customers' needs for bank services are becoming more sophisticated and more complicated. In order to respond to these needs, the world's banks are supplementing their traditional deposit-taking and lending services with a new, wider range of services. Examples include foreign exchange, securities-related services such as investment advice and underwriting, and derivative products such as swaps, options and futures. In most cases, pricing of these services depends on the strength or weakness of each bank in each field (much would depend also on differences in strategy).

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[2] The question of bank insurance powers is less pressing in Japan at this time. The Insurance Council, an advisory body to MOF, started discussion last year on the subject of a desirable insurance system for Japan.

No universal measure for competitiveness exists, however. Competitiveness can be evaluated based on a range of different key measurements which may lead to conflicting conclusions. For example, profitability, as seen in terms of return on equity and return on assets, is one possible measurement while capital ratios, indicating potential cushion against risk, also may be used.

There are also other possible ways for measuring competitiveness that cannot be described in terms of actual figures, such as the ability to develop new financial techniques, and risk management performance. Presumably, the true competitiveness of a bank can be measured by means of computations that take all of these various factors into consideration.

2. Asset Size

In recent years, Japanese banks have ranked as the largest in the world in terms of asset size and it is often argued on that basis alone that they are very competitive in the world market. However, based on the argument above, I believe that gauging the competitiveness of a bank solely or even primarily on the basis of asset size or amount of loans is misleading. Bank services have recently become increasingly diversified, and deposit-taking and loans are now just two among a long list of services offered. Moreover, numerous other measures of bank competitiveness are available and may be even better indicators.

When interest rates on deposits were fully regulated, a profit margin between loans and deposits was assured, so that any increase in assets led directly to greater earnings. However, with the deregulation of deposit interest rates and the expansion of the scope of banking services, asset size is no longer an accurate indication of whether a bank is competitive. In recognition of this, in 1989 the authoritative British financial magazine The Banker altered the measures on which it bases its annual list of the top 500 banks in the world from total assets to total capital (see Appendix Table 3).

Moreover, the assets of the Japanese banks are often compared with those of banks of other countries on a dollar basis, but it is important to remember that such comparisons can be misleading, particularly due to fluctuating exchange rates. For example, in the four years between 1985 and 1989, the yen appreciated by about 50% against the dollar. Under these circumstances, a Japanese bank's assets calculated on a dollar basis would automatically double, even though its yen-based assets may not have increased at all. Differences in accounting is another factor. For example, in Japan, contingent liabilities such as letters of credit and guarantees are included in assets and liabilities while they are off-balance sheet items in the United

States. (For your reference, the letters of credit and guarantees provided by Fuji Bank in March 1990 accounted for about 10% of its total assets.)

B. Two Different Aspects

At this point I would like to return to the discussion of the meaning of "competitiveness." I believe that competitiveness has two different aspects. First, there is relative competitiveness, whereby we measure the competitiveness of the banking business of a particular country against that of other financial businesses, including the securities, insurance, non-bank and information service sectors in the same country. Second, there is global competitiveness, that is, the strength of a domestic bank compared with that of its overseas counterparts. I would like to examine this problem further from these two distinct measures.

1. Competitiveness of the Banking Industry

When we compare banks with other financial institutions, clearly both Japanese and U.S. banks are experiencing a relative decline in competitiveness. Banks have been affected by the financial distintermediation initiated by the introduction of money market mutual funds and other products. On the corporate finance side, banks have had difficulties making new loans due to the growing commercial paper market. In addition, the deregulation of interest rates on deposits has increased the cost of funds. It is important to establish a level playing field between banks and other financial institutions which are not as strictly regulated as banks. There is no doubt that the absence of BIS capital guidelines and similar restraints on the activities of securities companies and non-bank institutions will weaken bank competitiveness.

Unfortunately, neither Japanese nor U.S. banks have been given new powers to cope with these structural changes. Without such new powers, their competitive position may be affected. Today's financial systems were created several decades ago; obviously there was no way at that time of anticipating the sort of structural changes that are now taking place. Among the new powers needed by Japanese banks to respond to these structural changes is the power to engage in underwriting and dealing in corporate securities. U.S. banks need similarly broad securities powers as well as the power to conduct nationwide banking.

2. International Competitiveness

In addition to the various factors affecting the competitiveness of the banking business vis-a-vis other members of the financial industry, I believe the following factors influence the international competitiveness of banks. They are: (i) economic performance of a bank's home country, (ii) the nation's financial system, and (iii) the management philosophies of individual banks. Another important issue in evaluating relative competitiveness is what banks to compare. Comparing all the banks in major countries is not reasonable because they often have specialized institutions that vary considerably in business scope, size, profitability, and international exposure. For this reason, I believe that a comparison should be made only of top tier banks that have similar lines of business and are active in international markets. Such banks would include U.S. money center banks, European universal banks, and Japanese city banks.

a. Macroeconomic Factors

A bank's competitiveness is largely influenced by the overall economic performance of its home country. Needless to say, the goal of economic policy is the achievement of stable economic growth with low inflation. From the viewpoint of flow of funds, the cost of capital will generally be lower when the domestic investment-savings ("I-S") balance tips in favor of savings. If domestic savings exceed investment, there are more funds available than are needed in the country. In contrast, if domestic investment exceeds savings, there are less funds than are needed in the country. Due to the supply-demand structure of funds, the cost of funds is relatively cheaper in the country with a savings surplus.

The factor that affects the I-S balance most is the excess or shortage of funds in the three key economic sectors, the public, corporate and individual sectors. A look at the I-S balance in Japan and the United States (see Appendix Table 4) shows that Japan's personal sector boasts a surplus while the U.S. public sector has a huge deficit (see Appendix Table 5 for a comparison of savings rates). In testimony before the House Banking Committee's Task Force on the International Competitiveness of U.S. Financial Institutions, Dr. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, stated that in order to boost the competitiveness of U.S. banks, it is necessary "to reduce the cost of capital" and to take policy steps resulting in "changing the macroeconomic environment."

b. Financial Systems (seen from Fuji Bank's viewpoint)

The primary objective of reforms to the system are to promote convenience of the user while enhancing the overall efficiency, safety and soundness of the system. Reforms should be made expressly for the benefit of users, but they also influence the competitiveness of banks that are based in the market in question. When I say "efficiency" here I am referring to a system, based upon the premise of a fully competitive market, which allows financial institutions to provide a broad spectrum of services to their customers. If bank competitiveness can be measured by the quality and price of the services offered, then the banks of a country whose financial system and infrastructure allow a broader range of services at attractive prices will be most competitive.

In Japan, we are in the middle of discussing possible financial system reforms. We have a consensus that the safety and soundness of the system are essential for its stable operation. There is a view, however, that these two objectives conflict with the pursuit of efficiency. If efficiency is the sole criterion, then a universal banking system that allows banks to offer a wide range of services, including securities underwriting, is ideal. On the other hand, if priority is given to the safety and soundness of the system, then in order to overcome potential problems such as conflicts of interest (that might arise once banks and securities companies are allowed to engage in each others' businesses), it has been argued that it is necessary to erect firewalls to protect depositors. The most important thing is to ensure a proper balance between efficiency on the one hand and the safety and soundness of the system on the other.

We at Fuji Bank believe that in order to exploit a bank's managerial resources to the utmost, a universal banking system that allows the achievement of economies of scope (combination) is the most desirable. Universal banks can offer a variety of services to corporate and individual customers who can, as a result, obtain all of their financing and investment needs through the same supplier. Because of the synergies of combining all services into one financial firm, prices can be reduced. Potential problems in the concurrent conduct of the banking and securities businesses can be solved as they are in the European countries by thoroughgoing internal controls (Chinese walls) and disclosure arrangements. Overly strict firewalls sharply diminish the potential benefits of combining the banking and securities businesses. A "constructive ambiguity," as Mr. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, put it, should be considered here.

In this sense, the trend in the EC toward a universal banking system, is very important to Japanese banks. Financial globalization allows customers to seek the best services and conduct transactions with any bank in the world. From the viewpoint of the services available, universal banks are the most competitive. If Japan maintains a fragmented financial system, our banks will find competing with universal European banks increasingly difficult.

As the debate over the reform of Japan's financial system continues, we are therefore strongly recommending the introduction of a universal banking system.

c. Management Philosophies

Management philosophies, strategies and goals also affect a bank's competitiveness. Differences in management can sometimes account for the large differences in business performance among banks in the same country.

First of all, a bank's strategies will be largely determined by the ultimate goals of management, as well as by an inclination toward either a long-term or a short-term strategy. The answer to the problem of whether to dispose immediately of an undertaking that is currently losing money or to retain it for its potential profitability will be influenced by the time horizon established as part of the bank's goals. Differences in the decision-making processes (centralized or decentralized), also affect competitiveness. Although one method cannot be declared superior to all others, differences in managerial approaches affect a bank's competitiveness.

C. Possible Implications for the U.S. System

So far I have made some comparisons of the Japanese and U.S. financial systems and enumerated some of the factors that determine international competitiveness. Now, I would like to offer a few personal observations that may bear on your decisions.

1. Separation of Banking and Securities Activities

As I have already mentioned, the system separating the banking and corporate securities businesses can no longer cope with the fundamental changes such as securitization and globalization taking place in the financial sector and acts as an obstacle to the enhancement of banks' competitiveness. We are therefore advocating the repeal of such separation in Japan, and suggest a similar approach in the United States.

2. Geographic Restrictions

A system that does not allow banks to fully cover capital flows throughout the country is a major problem. The promotion of geographic asset diversification is also very important from the viewpoint of spreading risk. A bank that becomes dependent on one or two industries for its business because its market is limited is at greater risk than a bank that has a diverse geographic market. The latter bank has a greater opportunity to diversify its exposure to different industrial sectors.

3. The Safety Net

Any discussion of the problems of depositor protection and safety net that takes only the deposit insurance system into consideration is not enough. I believe it is important to try to prevent bank failures by detecting deterioration in asset quality and business performance at an early stage, in addition to dealing with bank failures once they have actually occurred. The frequent occurrence of bank failures in the United States fosters the view among investors in capital markets that the banking business is a risky one. This, in turn, increases the cost of capital.

A strong early warning system with detailed bank inspections and encouraging rescue mergers by private sector banks are good ways of preventing bank failures. However, increased supervision or stronger controls by the authorities should be limited to the minimum essentials and should not merely raise the costs to banks. Perhaps it is necessary to review the efficiency and quality of bank supervision.

D. National Treatment

When evaluating international competitiveness, the concept of national treatment is also important. In order to compare the operations of foreign banks in a particular country with those of a domestic bank, it is imperative to give them both regulatory and practical equality.

1. National Treatment in the United States

Under the International Banking Act of 1978, the U.S. operations of foreign banks are generally accorded equal national treatment within the U.S. federal bank regulatory framework. Although application of the national treatment principle in certain specific contexts will always be subject to debate, we also believe that, overall, our U.S. operations are enjoying virtually national treatment at the practical level.

2. National Treatment in Japan

Since the Japan-U.S. roundtable talks on the yen-dollar committee in 1984, significant and far-reaching regulatory changes have been made in Japan to assure that U.S. and other foreign banks wishing to establish and maintain local operations enjoy national treatment in fact as well as in theory. A list of the reforms that have been implemented to date is given in Appendix Table 6. Deregulation continues on a broad scale, and recent developments include the participation of foreign banks in government bond underwriting syndicates and the expansion of foreign banks' access to BOJ lending.

In Japan and the United States, there are inherent differences in the legal status and market orientations of local operations of foreign banks as compared with domestic banks. In Japan, these differences have been taken into consideration by the governmental authorities in departing from strict de jure equal treatment by providing better than national treatment in certain areas of regulation. Better than national treatment has included the ability to establish securities subsidiaries and trust bank subsidiaries as well as a flexible approach on the opening of new branch offices. Ordinary banks in Japan are not permitted to establish such subsidiaries and remain under branch opening controls.

Some Japanese banks complain about this "super national treatment." But I welcome this development because such new powers are just what we want to have in the very near future for ourselves.

Despite the reforms that afford foreign banks better than national treatment in certain areas of regulation, we have heard complaints from foreign banks that they are unfairly treated in their ability to introduce new financial products in Japan. However, their inability to rapidly offer new products does not involve a question of national treatment. Indeed, we Japanese banks have the same complaints and ask MOF to make improvements.

The market share and, ultimately, the competitiveness, of U.S. banks in the Japanese market is often measured only by "on-balance sheet" asset size. But the main activities of U.S. banks in Japan, consistent with the overall strategy of U.S. banks in recent years to emphasize profitability and de-emphasize "on-balance sheet" asset size, are in "off-balance sheet" transactions such as M&A mediation, foreign exchange and government bond dealing, and derivative products. The major Japanese corporations now base their decisions in such new financial service areas on the terms of each individual transaction, and recognize that U.S. banks are often more active in these areas than their Japanese counterparts. Consequently, it is misleading, I believe, to evaluate the competitiveness of U.S. banks in Japan solely in terms of "on-balance sheet" asset share.

IV. CONCLUSION

In these times of financial globalization, customers are increasingly finding that they are free to choose the most beneficial services provided by financial institutions around the world. The financial system of any major country can no longer be independent from the world economy. If the financial system of any such country were to collapse, the consequences would be felt immediately throughout the world. In this sense, policies for international standards, such as the BIS capital adequacy guidelines, are gaining greater credence and support.

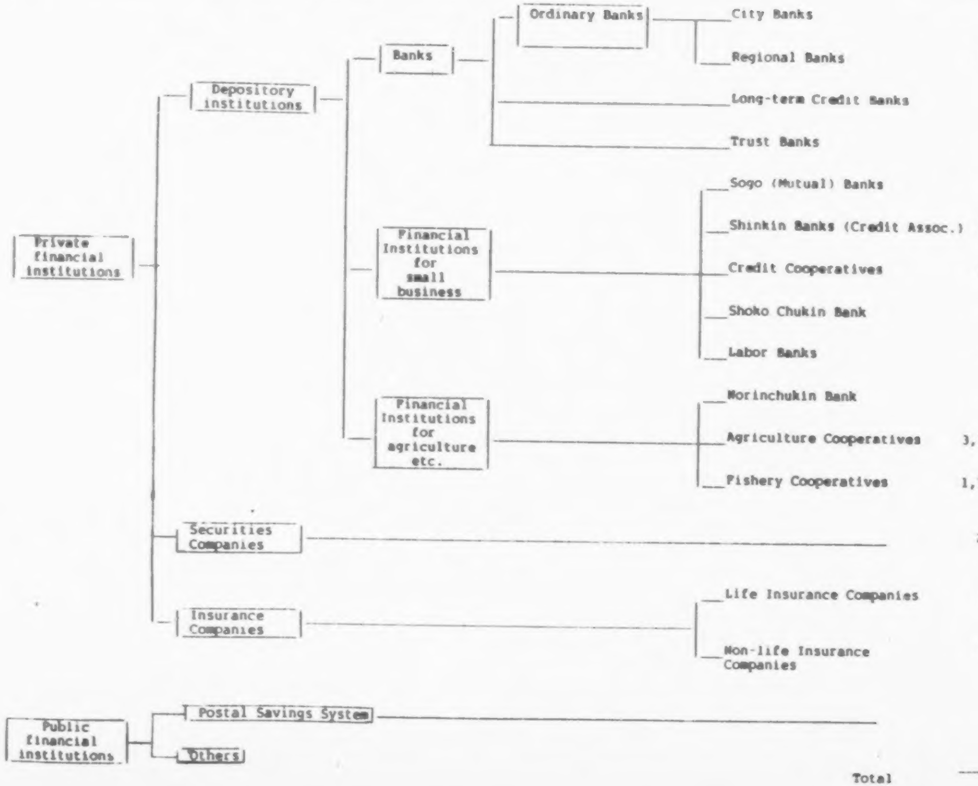
At the same time, however, each nation's financial system possesses a distinctive history and set of problems that must be recognized. The most critical issue now facing major industrialized nations is the question of how to reconcile financial globalization with efforts to create the most desirable financial system for each individual nation. There is no simple solution. Yet, it is imperative for us in Japan, the United States and Europe to join forces in the construction of efficient, stable and sound financial systems. This also requires mutual efforts to harmonize and converge regulatory philosophies and practices. Nevertheless, it should be clearly understood that all of our efforts should be based upon ensuring that free-market principles function properly. We have been given the responsibility of engaging in competition amidst cooperation.

Attachments

Appendix Figure 1

(Notes to this Figure 1 appear on next page)

Financial Institutions in Japan (As of Dec. '89)



				Number of Institutions	Deposits (trillion yen)	Dollar equivalent (billion dollar)	Share (%)
Private financial institutions	Depository institutions	Banks	Ordinary Banks: City Banks	13	210.6	1,469	21.1
			Ordinary Banks: Regional Banks	130	192.8	1,344	19.3
			Long-term Credit Banks	3	51.5	359	5.1
			Trust Banks	7	109.9	766	11.0
		Financial Institutions for small business	Sogo (Mutual) Banks	2	-	-	-
			Shinkin Banks (Credit Assoc.)	455	74.7	521	7.4
			Credit Cooperatives	415	19.1	133	1.9
			Shoko Chukin Bank	1	11.9	83	1.2
			Labor Banks	47	6.7	47	0.7
		Financial Institutions for agriculture etc.	Norinchukin Bank	1	60.5	422	6.0
			Agriculture Cooperatives	3,769			
			Fishery Cooperatives	1,709			
	Securities Companies			210	-	-	-
	Insurance Companies		Life Insurance Companies	25	109.1	761	10.9
			Non-life Insurance Companies	24	21.0	146	2.1
Public financial institutions	Postal Savings System			1	132.9	927	13.3
	Others						
			Total		1,000.7	6,978	100.0

Data: BOJ Economic Statistics Monthly

Notes to Figure 1

1. City banks include: DKB, Sumitomo, Fuji, Mitsubishi and Sanwa. As of April, 1990, due to the merger of Mitsui and Taiyo Kobe, the number of city banks was reduced to 12, and the total number of banks was reduced to 152.

2. A regional bank is usually based in the principal city of a region and conducts the majority of its operations within that region while a city bank has a head office in a major city, such as Tokyo or Osaka, and conducts its business nationwide.

3. 66 out of 68 Sogo (Mutual) Banks have been recently converted to ordinary banks. The number of regional banks, 130, includes these 66 new regional banks. The deposits of the remaining 2 Sogo (Mutual) Banks are included with that of regional banks.

4. Deposits include debentures in the case of long-term credit banks and trust assets in the case of trust banks (except Mutual Fund Trusts and Investment Management Trusts).

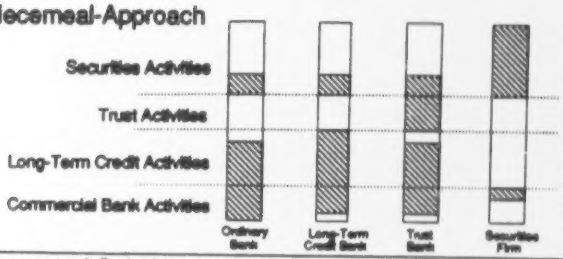
5. For insurance companies, deposits refers to the total of assets under management.

6. Dollar equivalents are calculated for reference only. ($1 = ¥143.40 on Dec. 28, 1989)

FIVE FORMULAS

Appendix Figure 2

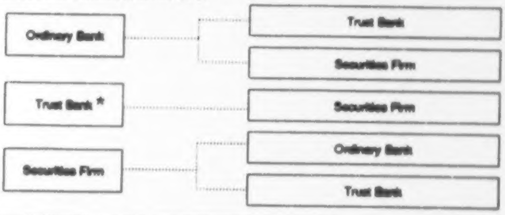
A. Piecemeal-Approach


Securities Activities
Trust Activities
Long-Term Credit Activities
Commercial Bank Activities
Ordinary Bank
Long-Term Credit Bank
Trust Bank
Securities Firm

To keep the basic system as it is and handle specific problems associated with particular financial instruments separately, allowing various types of banks and securities companies to gradually encroach on each other's business areas.

▨ - Denotes present activities

B. Separated Subsidiaries

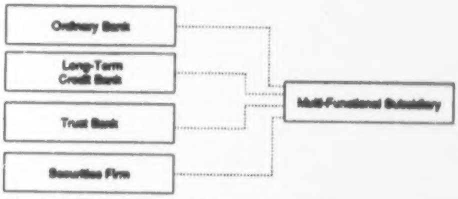

Ordinary Bank
Trust Bank
Securities Firm
Trust Bank *
Securities Firm
Securities Firm
Ordinary Bank
Trust Bank

To authorize banks and securities companies to establish wholly-owned subsidiaries in each of the specified financial areas.

e.g. Canada

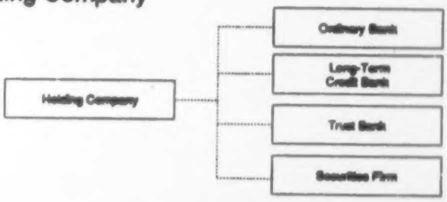
* Same as Long-Term Credit Bank

C. Multi-functional Subsidiary


Ordinary Bank
Long-Term Credit Bank
Trust Bank
Securities Firm
Multi-Functional Subsidiary

To allow each bank and securities company to newly set up a wholly-owned subsidiary which can (exceptionally) engage in a wide range of securities and banking activities within a certain limited field (e.g. wholesale)

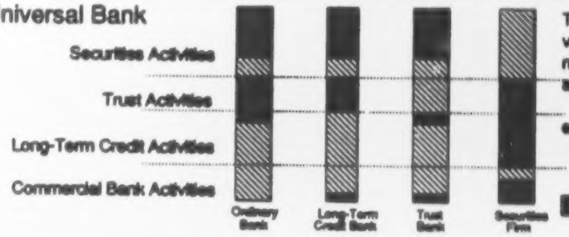
D. Holding Company


Holding Company
Ordinary Bank
Long-Term Credit Bank
Trust Bank
Securities Firm

To allow banks and securities firms to create holding companies which have various types of financial subsidiaries.

e.g. U.S. Proxmire Financial Modernization Act

E. Universal Bank


Securities Activities
Trust Activities
Long-Term Credit Activities
Commercial Bank Activities
Ordinary Bank
Long-Term Credit Bank
Trust Bank
Securities Firm

To introduce a European-type universal banking system, which does not distinguish between banking and securities businesses.

e.g. West Germany, France, U.K and other EC countries, Switzerland, etc.

■ - Denotes newly allowed activities

Appendix Table 1

Deposit Insurance Systems in the United States and Japan

* Dollar equivalents are calculated for reference only (at $1 = ¥143.40)

	United States	Japan
Name of institution	FDIC	The Deposit Insurance Corporation (DIC)
Establishment, Capital	1933, No capital	1971, ¥455 million ($3 million*)
Nature of the institution	Government agency, has power to regulate and inspect member financial institutions.	Special Corporation MOF, BOJ and private institutions each has 1/3 of the total share. No powers in inspecting or regulating member institutions
Total of Deposit Insurance Fund	$14 billion (Dec. 88) ... (1)	¥440 billion ($3 billion*, Mar. 89) ... (1)
Total Insured Deposits	$1,750 billion (Dec. 88) ... (2) (1)/(2) = 0.80%	¥446,397 billion ($3,113 billion*, Mar. 89) ... (2) (1)/(2) = 0.10%
Members of the system	National Banks, State Banks, State and Federal Mutual Savings Banks and S&Ls and others. Total 13,606 (Dec. 88)	Banks, Shinkin Banks, Credit Cooperatives, Sogo (Mutual) Banks and Labor Banks Total 1,085 (Mar. 89)
Insured deposits	Up to $100,000, per person per bank, including interest on deposits.	Up to ¥10 million ($70,000*), per person per bank. Deposit principal only.
Insurance premiums	Banks 0.12% (from 1991, 0.15%) S&Ls 0.208% (" , 0.23%)	0.012%
Source of funds	Insurance premiums paid by member banks and S&Ls.	Insurance premiums and special loan from BOJ (up to ¥500 billion).
Administration	Board of Directors (5 directors) Chairman and two directors appointed by the President. Comptroller of the Currency and Director of the Office of Thrift Supervision are also directors.	Management Committee (10 directors). Governor is a Deputy Governor of BOJ by law, 2 directors are DIC staff members and other 7 directors are chosen from member financial institutions.

Current Status of Deposit Interest Rate Deregulation

Appendix Table 2

	Large-denomination Time Deposit	MMC (Money Market Certificates)			NCD (Negotiable Certificates of Deposit)	
	Denomination	Interest Rate	Denomination	Maturity	Denomination	Maturity
Spring of 1985		CD rate minus 0.75%	¥ 50 million	1 to 6 mo.	¥ 100 million	1 to 6 mo.
October 1985	¥ 1,000 million (3 mo. to 2 yr.)					
April 1986	¥ 500 million (2 yr. or less)			1 mo. to 1 yr.		1 mo. to 1 yr.
September 1986	¥ 300 million (2 yr. or less)		¥ 30 million			
April 1987	¥ 100 million (2 yr. or less)	CD rate minus 0.75% (1 mo. to 1 yr.) CD rate minus 0.5% (more than 1 yr. to 2 yr.)	¥ 20 million	1 mo. to 2 yr.		
October 1987	(1 mo. to 2 yr.)		¥ 10 million	Automatic extension permitted		
April 1988	¥ 50 million				¥ 50 million	2 wks. to 2 yr.
November 1988	¥ 30 million					
April 1989	¥ 20 million					
June 1989		CD rate minus 1.25% (6 mo.)	¥ 3 million	6 mo., 1 yr.		
October 1989	¥ 10 million	CD rate minus 1.75, 1.25, 0.75, 0.5 (3, 6 mo., 1, 2 yrs.) 10 yrs. Treasury minus 0.7% (3 yrs.)		3, 6 mo., 1, 2, 3 yrs.		
April 1990			¥ 1 million			

Appendix Table 3

Top 10 Banks in the World

1988			
Rank	Banks (Country)		Capital ($million)
1	National Westminster	(U.K.)	10,907
2	Barclays	(U.K.)	10,545
3	Citicorp	(U.S.A.)	9,864
4	Fuji Bank	(Japan)	9,018
5	Credit Agricole	(France)	8,740
6	Sumitomo Bank	(Japan)	8,550
7	Daiichi Kangyo Bank	(Japan)	8,481
8	Mitsubishi Bank	(Japan)	8,200
9	Industrial Bank of Japan	(Japan)	8,155
10	Sanwa Bank	(Japan)	7,567

1987			
Rank	Banks (Country)		Assets ($million)
1	Daiichi Kangyo Bank	(Japan)	270,782
2	Sumitomo Bank	(Japan)	250,568
3	Fuji Bank	(Japan)	244,057
4	Mitsubishi Bank	(Japan)	227,527
5	Sanwa Bank	(Japan)	218,197
6	Industrial Bank of Japan	(Japan)	215,605
7	Credit Agricole	(France)	214,382
8	Citicorp	(U.S.A.)	198,388
9	Norinchukin Bank	(Japan)	186,534
10	Banque Nationale de Paris	(France)	182,675

Data: The Banker

Appendix Table 4

Domestic I-S Balance

	Year	Government	Corporate	Individual	Domestic Surplus/Deficit
Japan (billion Yen)	1984	Δ6,237.7	Δ13,528.6	26,838.0	7,071.7
	85	Δ2,603.6	Δ17,534.6	30,176.5	10,038.3
	86	Δ3,138.6	Δ16,339.7	32,073.5	12,595.2
	87	2,335.6	Δ20,348.0	29,248.2	11,235.8
	88	7,613.9	Δ30,101.4	31,661.2	9,173.7
U.S.A. (billion dollars)	1984	Δ105.0	8.7		Δ96.3
	85	Δ131.8	22.2		Δ109.6
	86	Δ144.1	10.1		Δ134.0
	87	Δ110.1	Δ36.1		Δ146.2
	88	Δ96.1	Δ11.7		Δ107.8
	89	Δ104.9	28.5		Δ76.4

Data: U.S. Dept. of Commerce: Survey of Current Business
Economic Planning Agency, Government of Japan

Appendix Table 5

Personal Savings Rate

(:%)

Year	Japan	U.S.A.	U.K.	West Germany	France
1984	16.0	6.1	6.6	11.4	14.5
85	16.0	4.4	5.4	11.4	14.0
86	16.4	4.1	3.1	12.2	13.2
87	15.1	3.2	0.8	12.2	11.5
88	14.8	4.2	--	12.6	12.2
89	--	5.4	--	--	--

Data: Same as table 4

Major actions affecting the activities of foreign financial institutions in Japan

ITEMS	1984	85	86	87	88	89-
Trust business by foreign banks	° The announcement of basic concept and criteria of approval.	° 9 banks (6 of which were US banks) gained licenses.	° All 9 banks commenced business.			
Security business by foreign banks		° Branch licenses were given to the subsidiaries of European universal banks.	° 6 foreign firms gained memberships on Tokyo Stock Exchange (TSE).	° Branch licenses were given to the subsidiaries of US banks.	° Another 16 foreign firms gained TSE membership.	° MOF announced its intention to grant bank branch licenses to subsidiaries of foreign securities firms. ('90)
Access to Government Bond market	° The participation of foreign banks in underwriting syndicates began. ° The commencement of selling and dealing by foreign banks.		° Foreign banks' syndication share was increased. ° The introduction of auction system (10 and 20-year Government Bonds).	° Another increase in syndication shares of foreign banks and security firms. ° The introduction of short-term Government Bonds.		° 4 foreign securities firms became syndication managers. ('89)
Money Market and Others		° The establishment of a new call market (no collateral required).	° The establishment of Tokyo offshore market.	° The establishment of domestic CP market.		° The establishment of Tokyo International Financial Futures Exchange. ('89) ° The expansion of foreign banks' access to BOJ lending. ('89)

The **Chairman**. Thank you very much also for an excellent summary and set of comments. I think your emphasis on financial globalization and the fact that the new world is here and we are all part of it and that we have to figure out how to work it smoothly together is really a key theme that I think is woven throughout what has been said.

I want to welcome Senator Bryan, who has joined us here.

Before starting the questioning, let me just invite Senator Bryan to make any initial comments he might wish to make here.

Senator **Bryan**. Thank you very much, Mr. Chairman. I will await my turn in the round of questioning.

The **Chairman**. Very good.

I was struck by the great number of points that were made. I want to make one other observation before starting the questioning, and that is that I think today is an illustration of something very important, namely, that we are sitting together to try to think through the ramifications of this new global financial system that has come into being, and it is quite unusual for Members of the Congress to invite in international witnesses such as yourselves on a subject of this kind.

But I think what we're seeing is a part of the new order of things in the sense that we can't just think alone any longer in individual terms. We've got to think in a broader context, and certainly this hearing is a reflection of that.

So I think we made a little history today, and I can't think of three witnesses who might in a more distinguished way help do that than the three of you have done thus far today.

So, again, I thank all of you.

Now our friend from Deutsche Bank made a very provocative comment earlier with respect to saying that in his view there was an overcapacity in the banking industry and one assumes that means essentially in this new global marketplace as well, and that suggests that there is going to have to be a consolidation and a sorting out.

I would like our other two witnesses to respond to that.

Mr. Leslie, would you agree with that, take issue with that, or what would be your view?

Mr. **Leslie**. I think I would accept that quite clearly, Mr. Chairman, that we are seeing overcapacity in certain areas. But yet at the same time we are seeing a tremendous appetite for new entrants to quite a number of the markets that up to now have been seen as traditional banking and securities markets.

I think it is desirable that we continue to see the efficient and successful prospering and those who are less so actually shaking out and dropping out of certain sorts of business.

It's quite interesting that in the discussions, strategic discussions that every bank in Europe is having, they are tending to say, right, we do want to be a universal bank at the top, and we do want to stand on our own, but quite a number of others, particularly in some of the smaller Scandinavian countries and the Netherlands are saying we are not actually big enough to survive in this very much tougher area. Either we've got to amalgamate and make ourselves bigger, or we actually have to decide that we are in a particular focus of the market. We cannot be in all the markets.

So I think that there are a lot of changes going on, and I think they are very desirable changes that we do actually see a steady shakeout of actual financial institutions over the next decade in response to the forces of the market.

The **Chairman**. Mr. Kusukawa, what would be your comment?

Mr. **Kusukawa**. Well, there may be some overcapacity generally in the international sphere, but I believe that overcapacity is more a function of each domestic banking market.

In Japan, for example, we have only 152 banks now. We used to have about 2,000 but during the course of the Great Depression and all that happened in its aftermath, we came down to this number. So in this sense you probably feel that we haven't yet experienced overcapacity, but still we feel that there is a certain amount of overcapacity in Japan. As we go through the final stages of deregulation of the interest rates and so on, there will undoubtedly be differences that surface in the performance of the banks, which may well result in a readjustment in the numbers of the banks.

As far as the international side is concerned, I would think that in Europe, where the single market is being implemented, that there must be some adjustments. But in Asia or the Pacific region, I don't see so much overcapacity for the time being.

The **Chairman**. Now, one of the arguments that we hear advanced on behalf of banks in the United States is that they want to broaden out their activities either by removing Glass Steagall or even the Bank Holding Company Act, which prevents, in this country, banking and commerce generally from affiliating directly, that the underlying argument is that with the squeeze on profits in the existing business lines, you've got to have the new business lines in order to have enough opportunity to really succeed and to be capital attractive and so forth.

On the other hand, it looks to me like that when any established area of business tries to move into somebody else's territory, it's not exactly as easy as it looks.

We had a situation, and I don't want to overplay the savings and loan example, and you're obviously familiar with it in this country, but over the last decade a large part of the argument for a rapid expansion, first by the Federal Government and then greatly enhanced by individual State governments with State chartered institutions, was to broaden out and allow savings and loans and thrift institutions the opportunity to get into new lines of business with much higher risk profiles, and it didn't work out very well.

Problems accumulated and they tended to be concentrated in certain areas and very much associated I think with the problems where States went even further to create a charter that looked attractive and looked like it was going to be a big money maker. It ended up being a big money loser, and now the Federal deposit insurance is on the hook for that.

I'm just wondering in looking at this from your own respective vantage points, can we automatically assume that if we open up new lines of activity that have heretofore been off limits to banks that that necessarily is a solution in terms of profitability, greater size, more consolidation and greater strength? Does one follow the other? I'm just wondering what your own view is on that?

Mr. **Leslie**. Shall I lead off?

The **Chairman**. Yes, please.

Mr. **Leslie**. I think it's absolutely correct what you say, that there is no automatic relationship between the ability to go into new markets and the ability to make money.

I think by widening out the number of opportunities, you do give financial institutions a chance to broaden their base. I think what we have seen very often is how institutions limited to particular areas geographically or particular types of business have seen growth disappearing and going into other areas, and they have actually been denied the opportunity of widening the range of their business.

But it's only the business that actually manages that diversification and the development into new markets successfully and is satisfactorily supervised while doing so that is actually going to prove that that is a desirable development.

We in the United Kingdom have seen quite a significant development during the last 5 years in diversification, which we believe actually has strengthened and widened the opportunities of banks, and certainly in their ability to operate internationally.

The **Chairman**. I might just say before the others respond, and then I want to move on because I don't want to overtax my own time here during the questioning, one of the anomalies here with Federal deposit insurance, such as we have it, which tends to be quite different, is that the question is if you were to keep the existing Federal deposit insurance guarantees there, and you stretch out the charter of a banking institution, do you stretch out the deposit insurance with it, or if you're going to maintain some near form of the current deposit system, do you keep it under only part of the institution and, if you are going to enlarge the institution and change the risk profile, do you stretch the deposit insurance out and keep it underneath those new activities as well?

It's a very, very complex and difficult question that we're approaching here, but let me just hear, if I may, the responses of our other two witnesses, and then I'll go to Senator Heinz.

The **Chairman**. Yes, Mr. Cartellieri.

Mr. **Cartellieri**. The short answer to your last point, Mr. Chairman, is of course simple only in theory, in practice it's much more difficult, that the insurance premium of the deposit insurance would also have to change in accordance with the change of the risk profile.

If I could elaborate on your first question, and it's very much along the lines of my colleague. Why have we in Germany found it necessary to diversify our banking business? If I may give you one example, Mr. Chairman, which has made headlines and was very much discussed in Germany at the time, and that was our entry into life insurance.

Deutsche Bank established its own life insurance from scratch about 2 years ago, and there were two reasons for this. No. 1, we had observed for more than a decade an ongoing erosion in our retail deposit base, a trend of household savings away from banking savings, from bank savings accounts into life insurance and, No. 2, we found an erosion in the products we sold profitably through our retail network. We have more than 1,100 retail branches on the domestic side.

The most attractive product taken away from us was car loans in the consumer credit business. This was more or less completely taken over within a few years by the automobile industry who established their own consumer credit banks. So we lost a key product in our retail branch network and we had to find new products to keep brick and mortar banking going and profitable.

The answer to both was in this case life insurance. It is still contested and disputed by some people, but we think it was a good decision and, contrary to what our friends in the insurance industry tell us, we think it will be a very viable business.

Mr. **Kusukawa**. Regarding deposit insurance, I doubt that deposit insurance can be expected to cover and solve the problem of protection of depositors. Our deposit insurance system in Japan plays a relatively small role in the overall "safety net." Correspondingly, the size of the insurance fund is also relatively small—probably 400 billion yen, which can be increased with the Bank of Japan's additional credit up to about one trillion yen. Even at that level, however, the fund could probably cover only one small bank's failure. So this is a very meager amount indeed.

It therefore goes without saying that we must stop failures from occurring in the first instance; and, if we can mutually help the failing banks to recover, then the ultimate purpose is fulfilled at least equally well.

For this reason, I feel that the deposit insurance system, standing alone, cannot really solve the matter. Rather, I believe that we've got to have some very strong supervisory functions whereby you can have an early warning system.

But then again, you have 13,000 banks to supervise, and we've got only 150 banks to supervise. That is a big difference that has important implications for supervisory and managerial resources within the banking system. I really don't know how you can cope with that sort of situation.

Regarding the other point—relating to bank powers—which you mentioned earlier, we also have experienced so-called securitization, and quite a lot of activities of nonbanks are encroaching on the services traditionally provided by the commercial banks. We have also a very strong capital market, and a commercial paper market which was introduced in Japan along the lines of the United States model. Because of these developments, banks in Japan are having a very hard time because we can't really keep up relations with corporations as we enjoyed in the past. So we are losing competitive ground against these securities companies and nonbank financial institutions and others.

It is therefore quite natural that we want to recover some of our lost areas to maintain our diversity and strengthen, and in doing so probably we should have some limitations taken away so that we are authorized to do something more. But whether particular new lines of business will ultimately be profitable or not is, as Mr. Leslie said, a function of the bank's management.

The **Chairman**. Thank you very much, all of you, and I appreciate the patience of everyone to allow me to pursue that question. Senator Heinz.

Senator HEINZ. Mr. Chairman, I think that was a very important question, and I think you got some very good and helpful responses to it. So I'm glad you did persist in it.

When I mentioned Senator Dodd and I were over in EC and we visited your bank, Mr. Cartellieri, with both the Deutsche Bank and other bankers, we asked them how are universal banks going to succeed in competing against the kind of more differentiated banking structure in the United Kingdom where they have nonbanking securities firms as well as merchant banks as well as kind of semi-universal banks.

And your colleagues very modestly said we're going to win. [Laughter.]

The universal banking model is the model, and somebody who is not a universal bank won't be able to compete with us.

When we went to the United Kingdom, Mr. Leslie, the people in the securities business in the United Kingdom, your colleagues in that industry said, they are never going to have a chance. We specialize, we know what we are doing, bankers, we can run circles around them.

Who is right? [Laughter.]

Mr. Leslie, do you want to take a crack at it?

Mr. LESLIE. I think the move toward universal banking is one that we've been seeing developing steadily across Europe, and certainly in the United Kingdom, after all, it's a comparatively recent development, over 5 years only. The separation between securities and capital markets was really total before, and I think we are all going to develop our own models.

We certainly see the German type of universal bank as a very significant challenge, competitive challenge for us, particularly at the top end of the wholesale market, and in the securities markets generally we're going to fight them very hard, as hard as we can, to ensure that we're keeping our position and we're expanding in Europe in the same way as they are.

Who is going to be successful? I think it's almost invariably the question not of the systems or the structure, but it's the question of how good the management is.

Senator HEINZ. Do you believe the second Banking Directive creates a fairly level playing field on which the United Kingdom kind of nonbank firms can compete fairly and squarely with the universal bank model?

Mr. LESLIE. I think it certainly establishes a level playing field, and I think the nonbank players are going to have to stick very much to the niche markets in which they're in, and I think they will be able to have some success in that. I think life will become more competitive for them, too, but I think they've still got a role.

Senator HEINZ. Mr. Kusukawa, you have a debate in your country over the repealed article 65.

Mr. KUSUKAWA. That's right, yes.

Senator HEINZ. And I understand you come from the bank side of things, and there in a sense the banks are afraid, not unlike here, the securities firms are becoming too big and too powerful and taking some of their best customers away and so forth.

How much of the debate over article 65 has been about achieving a level playing field were it to be repealed? Is that something that is discussed?

Mr. KUSUKAWA. Yes, we have been discussing that.

Senator HEINZ. Do you understand my term, a "level playing field," a competitive quality?

Mr. KUSUKAWA. Yes, that's right. I understand it, yes.

We have been discussing these issues for the past several years, and the bankers are always saying why can't we get in, and the securities companies are saying that they are too small and too weak to meet the competitive challenge from the banks. Well, I don't really believe that.

We have had the Government Council, which is contemplating about changes in the financial system, and the Securities and Exchange Council, which is contemplating about what is to be the future of the securities market. We therefore, have two councils which are separately contemplating what is best for the future.

We have had quite a lot of discussions about it therefore, and now we have five different models or proposals from the Ministry. We now have to choose one out of those five. Although we are insisting that the universal banking model is, on balance, the optimal choice, it is quite possible that the option selected would require a separate subsidiary of the organization. I think that this approach would create a fairly level playing field.

Senator HEINZ. Let me ask you all in effect a continuation of the question Senator Riegle asked, one having to do with deposit insurance.

There is a point of view of some observers here in this country that the ability of banks to attract low-cost deposits, a courtesy of our deposit insurance system, which of course is much more generous than anything in any of your countries, provides banks with a competitive advantage, and that if you really want a level playing field you have to find some way to nullify or eliminate that competitive advantage in order for banks and securities firms to play on the field with competitive equity.

Do you believe that deposit insurance in your countries, and I recognize they are all different, creates any kind of a competitive funding advantage for banks and, if not, why not?

Mr. Kusukawa.

Mr. KUSUKAWA. No, it doesn't. First of all, we don't put up any signs that our deposits are insured. We don't really try to entice our depositors just because of deposit insurance. Second, almost all our depositors don't even realize that we have insurance coverage. So I don't think that we have that sort of competitive edge.

Senator HEINZ. What about in Germany, Mr. Cartellieri?

Mr. CARTELLIERI. I think it's similar in the last respect. Depositors no longer realize that they are insured. They take it for granted. From an industry point of view, the system obviously advantages the weaker competitors in that it allows them to attract deposits at even higher rates than they could otherwise if they were not insured and protected by the system.

This is subject to debate within the industry in my country.

Senator HEINZ. What is the question that is debated, whether there is a competitive advantage?

Mr. **Cartellieri**. Well, whether the quantitative deposit insurance is the right approach or whether there should also be some sort of a qualitative approach. There is no outcome to be expected soon, but the discussion is on its way.

Senator **Heinz**. There is going to be some kind of, or there may already be as part of the second Banking Directive a general EC-wide policy on that; is that not correct?

Mr. Leslie, do you have any comments on that?

Mr. **Leslie**. Yes, there is a requirement in it that there should be deposit protection arrangements. In the UK these are comparatively recent. They only date from 1979. In fact, the Board wasn't actually set up until 1985. It certainly I think at present has had no competitive impact for very much the same reason as it is not appreciated that it exists.

Senator **Heinz**. Why did you set it up then?

Mr. **Leslie**. Because we were obliged to set it up by law following the banking crisis of the early 1970's, where indeed the fact that there was no form of support whatsoever meant that the Supervisor or the Bank of England, rather, because he wasn't at that time the Supervisor as such, actually came in and organized with the leading commercial banks a rescue system. So it was set up by an act of Parliament.

We fought very hard and successfully to limit, not as much as we would have liked to have done, the amount of the actual percentage coverage.

Senator **Heinz**. So the way your system is set up it doesn't have much competitive impact. As you look at our system, do you think it has competitive impact?

Mr. **Leslie**. Yes, it must, and I think it is a well publicized system. Everybody is aware of it, and it must indeed provide a degree of protection and satisfaction.

Senator **Heinz**. And I gather there is no disagreement with that. Very well.

My time has expired, gentlemen. Thank you very much.

Senator **Shelby**. Gentlemen, I would like to followup on the deposit insurance funds in your respective countries.

First of all, what size fund, for example, would you have in the United Kingdom, Mr. Leslie?

Mr. **Leslie**. The size of the fund is limited to I think 100 million pounds. It's drawn down under quite a complicated——

Senator **Shelby**. Drawn down from the losses or what?

Mr. **Leslie**. A minimum amount is actually drawn down by calls on the individual members of the banking system.

Senator **Shelby**. Is it administered by the Bank of England?

Mr. **Leslie**. It's administered by the Bank of England. It has a mixture of members, some of which are from the commercial banks and some from the Bank of England.

Senator **Shelby**. And in the United Kingdom, for example, if I had a saving account in your bank, in Barclays Bank, and I had $100,000, would it be totally insured, partially insured or insured to how much?

Mr. **Leslie**. It would be insured to, I think it's to 20,000 pounds.

Senator **Shelby**. Up to 20,000 pounds.

Mr. **Leslie**. Up to 75 percent with a maximum of 20,000 pounds.

Senator **Shelby**. It's got a ceiling of 20,000 pounds.

Mr. **Leslie**. Yes.

Senator **Shelby**. Like we have a ceiling of $100,000.

Mr. **Leslie**. Yes.

Senator **Shelby**. And it would only insure 75 percent of your deposit in case the bank failed?

Mr. **Leslie**. Yes, indeed, and only for personal individuals, and the arguments have usually been about whether somebody has actually put money through somebody else, but is purely for personal.

Senator **Shelby**. What about Germany, and how does it work, the mechanics of it?

Mr. **Catellieri**. As I said, we have three systems. The public sector, the corporate sector and the private banks each run their own deposit insurance, privately and autonomously.

Senator **Shelby**. Three separate funds?

Mr. **Catellieri**. Three separate funds with no Government interference and no Government support.

The private system collects fees from its members, and membership is voluntary, but practically close to a 100 percent.

Senator **Shelby**. From all the banks in Germany?

Mr. **Catellieri**. All the banks in Germany.

Senator **Shelby**. The 4,000 banks.

Mr. **Catellieri**. Well, of the 300 private banks. The other banks would be organized under the public sector and the corporate sector fund.

The private sector fund collects fees from its members. Regularly about 0.03 percent of total deposits is charged or collected as a fee. Fees may be doubled in case of need and extra collections may be made in case of need. So the fund is very flexible to call for extra funds when it feels it needs more from its members.

Senator **Shelby**. In Germany is the depositor, the consumer or the small business or large business, is that person or company mainly looking at the soundness of the bank to put the money in rather than looking at the deposit insurance fund that would take care of them in case the bank failed?

Mr. **Catellieri**. I would say the more sophisticated depositor is certainly looking at the soundness of the institution. The man in the street——

Senator **Shelby**. The retail, the small retail.

Mr. **Cartellieri**. The retail depositor, apart from very tiny private banks of which we still have also a few, would normally think that his deposit is protected anyway, which in practical terms it is up to the full extent.

Senator **Shelby**. What about Japan, how does it work?

Mr. **Kusukawa**. Well, the limitation on the insurance coverage is 10 million yen. That is about $70,000, and it covers only the principal, not the interest accrued. So it's a full payment up to 10 million yen per person per bank.

The organization is a corporation established under the Ministry of finance, which has a shareholding of one-third, and another one-third is held by the Bank of Japan, and another one-third is held by the private banks.

Senator **Shelby**. Was this set up by the Japanese Diet?

Mr. **Kusukawa**. Yes, that's right, under the special law.

Senator **Shelby**. What size fund would you have there now?

Mr. **Kusukawa**. Well, right now I think we have about 450 billion yen. There is also the facilities in case of need. The Bank of Japan can extend credit up to 500 billion yen to this company. So in total it comes to around 1 trillion yen. That is probably about 0.2 percent of the whole of the covered outstanding deposit amounts.

Senator **Shelby**. Let's give a case example. Let's say I had $100,000 or the equivalent of $100,000 in yen, however it translates today, in your bank.

Mr. **Kusukawa**. Yes.

Senator **Shelby**. How much of that would be insured in case your bank went under?

Mr. **Kusukawa**. If we went bankrupt, you will get only $70,000 back.

Senator **Shelby**. You would get partial, just like the United Kingdom.

Mr. **Leslie**. Can I make a correction, sir?

Senator **Shelby**. Yes, sir.

Mr. **Leslie**. The actual amount of the fund currently goes between 5 million pounds only minimum with a maximum of 6 million pounds. The subsequent calls on levies, if the amount is very significantly larger, have to be done with the agreement of the Treasury, and I'm afraid I cannot recall what the upper limits are, but if I can come to you on that, sir.

Senator **Shelby**. In any of your respective countries is there any express or implied backing by the Government in case these funds were depleted in the deposit insurance fund? Let's say that the fund was used up, like the savings and loan fund was, will the respective Governments of the United Kingdom, Germany or Japan step in and make good this money, or is that speculation?

Mr. **Cartellieri**. I think it's speculation. It hasn't happened so far. The fund in the private banking system, and I assume the two other systems as well, is flexible in calling on members as much as necessary.

Now to imagine a case where the call would go beyond the capacity of the members is difficult to imagine. In that case of course, a case which by the way, was of minor magnitude, consultation with the Central Bank would be very close, but it is really guess work to figure out whether the Central Bank would step in or not and in which form it would do so.

The fact is, as I said earlier, we had a banking failure of a medium size private bank in the early 1980's, and, contrary to the statutes of the fund which would not have had to rescue the bank, it did rescue the bank and keep it going at the time.

Senator **Shelby**. All three of you are familiar with our problem here in this committee and in America because after the savings and loan funds were depleted, the Government, we stepped in with money to back you up, and I think you wanted to comment on that.

Mr. **Kusukawa**. Well, in our case, if we were to use up all the existing resources of the fund, we would expect the corporation to call its shareholders together to see how they can cope with the situation. That means the Ministry of Finance, the Bank of Japan, and the private bankers.

The president of this corporation is required to be the Deputy Governor of the Bank of Japan. So in this way we probably could work out a suitable arrangement if that sitution were to arise.

Senator SHELBY. But not to the extent of maybe $500 billion.

Mr. KUSUKAWA. No, no, no. That's a very big amount to tackle.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Shelby, and I appreciate your taking the witnesses through the deposit insurance comparison set of questions. That's very important.

Senator Graham.

Senator GRAHAM. Thank you very much, Mr. Chairman.

Mr. Kusukawa, in your statement you concluded with this observation. "The most critical issue facing major industrial nations at present is the question of how to reconcile financial globalization with efforts to create the most desirable financial system for each individual nation." I agree with that statement of the central question.

What would each of you suggest should be on the agenda of discussion of the international, particularly the industrial nations in terms of those matters which will require harmonization among the international financial community?

Mr. LESLIE. Shall I start, sir?

Senator GRAHAM. Yes, please.

Mr. LESLIE. I think that is a very challenging question indeed. I think the first one is certainly the question of the coordination of supervision, and there we have gone quite a long way down that road over the last few years.

I think it is the ability to coordinate also, the Central Banks to coordinate and understand the operation and risks in individual markets, and indeed markets generally, and I think that covers obviously things like what can go wrong with the foreign exchange markets. The question which they are now paying a lot of attention to the issues of settlement and what tremendous risks can build up as a result of settlement problems.

I think these are the sort of areas which have to be pretty high up on the agenda from the point of view of world discussions.

Mr. CARTELLIERI. I would agree, and I would add emphasis on supervision, Senator. I think coordination of supervision and improvement of professionalism of supervision would appear to be mandatory. It relates back to the questions on deposit insurance and why have we not had major surprise failures of the kind and numbers that we might have otherwise as so many failures happen in other industries.

In the financial industry in my country, the external auditors have to send copies of their external audit report to the banking supervisors on a regular basis. Apart from that, banking supervisors have the power to make surprise audits, full or specialized, on matters such as on foreign exchange and settlement, which they do on a frequent basis.

This perhaps relates also to the early warning system that Mr. Kusukawa referred to, which we find is most important to prevent accident and not to handle it after it has happened.

Mr. **Kusukawa**. Well, Senator Graham, on your question, we have, for instance, a 24 hours dealing system nowadays, which means that the world is divided into three parts, one in this country, the United States, and then you have Europe, and then we have the Asian region. Each area has about 8 hours to work, and so for the whole day of 24 hours somebody has been working, and in this way the world is continuously doing the business either in Tokyo, in London or in New York, and this automatically means that we have to live with the same sort of disciplines and the same sort of rationale, so to speak, because the financial services industries have become truly global and universal.

That's why I feel that in order to make industrial nations' future growth of economy, it's really necessary to depend on this system. So I feel that this is very important.

We now have efforts to harmonize things: for instance, the Stock Exchange settlement systems, and a sort of U.S. dollar settlement system.

You can imagine that if we in Japan are doing U.S. Dollar exchange dealings, it is a time that New York is still asleep. Although we conclude the transaction in Tokyo, in fact the final settlement can only be done when New York comes in the morning to work and our deal is settled in New York. Because of this interdependence, the potential repercussions are such that cooperation is essential.

Senator **Graham**. With that very constructive agenda of what the international financial community should be focused on as we move towards harmonization, what is your assessment of the current state of deliberations and negotiations among the Central Banks, other regulators as well as Ministers of Finance and the highest levels of Government towards achieving the necessary harmonization?

Mr. **Leslie**. I think there has been an enormous increase in the last 5 years on the question of the BIS agreements, the development of capital adequacy and the idea of supervision by home base. All of that has developed, and it's continuing to develop in these discussions. For instance, I think Mr. Corrigan certainly has played a very important part in discussions on settlement risk as well as a result of which they are now working towards agreements by which settlements should be consistent on stock exchange transactions around the world and they should comply with certain minimum issues.

Whether all of that is sufficient, I think it's very difficult to judge, but I think one could be very satisfied by the enormous amount of input that is going in now into the study and the solution of these problems.

Mr. **Cartellieri**. I think we can be satisfied with the high degree of awareness of the acuteness of the problems that exist now among central bankers and international bank regulators.

What we must be concerned about, and we are to some extent, is the focus on regulation, on the mechanics of regulating the market to be more specific. That makes regulation overly sophisticated and complex, unwieldly and difficult to handle, and even more difficult to understand. It becomes a matter for EDP specialists rather than for bank managers, and this trend is dangerous.

Senator **Graham**. That which you would describe as excessive focus on the regulatory aspects, that has been to the exclusion of what? What would you consider to be a more appropriate or balanced focus?

Mr. **Cartellieri**. The focus should be more on supervision, on regular screening of financial institutions and on their behaving in the marketplace rather than on regulating the quantity and quality of risks they take.

As long as these quantities and qualities are made transparent and quite visible to all other market participants, market discipline would see to it that these institutions don't get a wide standard, because otherwise they wouldn't find other people to play with them in the market any more.

Mr. **Kusukawa**. I think that from the private industry's point of view, the governments and the Central Banks know exactly where the problems and the questions are. With such common knowledge, I think, they have been working together rather nicely and well. I'm sure that in the future there will be further cooperation among them and it will enhance the quality of oversight of our industry.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Senator Bryan.

Senator **Bryan**. Thank you, Mr. Chairman.

Gentlemen, I would like to pickup on a line of questioning developed by Senator Shelby.

If I understood the testimony of each of you, it would appear that the deposit insurance system that you have is essentially a private sector organized system of deposit insurance. If I'm not correct, please disabuse me that. I gather with your nodding that I am correct.

Mr. **Leslie**. I think if I could just add a rider with us. It is imposed by law, and it is supervised and managed by the Bank of England. Thus, I don't think we can say that it is entirely. It's private sector in its costs, but we have to do it.

Senator **Bryan**. That would have been a more artfully framed question, and I thank you, Mr. Leslie.

We are also led to believe that if not by statute and not by an act of the Parliament, the Diet and the Bundestag, that in effect each of you have a system in which too big to fail, which is essentially what we have here, is implicitly part of that system.

Beginning with you, Mr. Leslie, am I correct on that?

Mr. **Leslie**. I think if the Bank of England were here rather than myself they would certainly deny it very fiercely. It hasn't been put to the test in recent years in the United Kingdom. We have had one case, Johnson Matthey Bankers, which was not a very large bank, but a very significant gold market operator where the Bank of England did indeed some 6 years ago step in and rescue the thing because they were frightened of the systemic risk to the market.

Senator **Bryan**. Would I be correct, though, and, please, if I'm misinformed, so advise me, that at least in conversation the general premise is that, look, if a financial catastrophe occurred, we would not allow that to occur, that ultimately there would be some Government intervention to prevent that.

Is that, if not the expressly stated policy of the Government, is that in the financial markets an accepted premise, or is that not?

Mr. LESLIE. Ten years ago in the United Kingdom that would have been an accepted premise. Today there is clearly a question mark as to what might happen, if that happened, and I think the pressure on the central banker would be very much you shouldn't have allowed it to happen, but also there shouldn't be taxpayers' money going into solving it.

Senator BRYAN. Mr. Cartellieri.

Mr. CARTELLIERI. Again, if our Central Bank would be here, they would probably deny the existence of this doctrine in very strong terms. As a market participant, on the other hand, I would say that the markets more or less are convinced that this doctrine exists.

Senator BRYAN. I appreciate your candor. Thank you.

Mr. Kusukawa.

Mr. KUSUKAWA. Well, in Japan I don't think that we have anything explicit about this doctrine of too big to fail. About 25 years ago we had one near-failure of a securities company whereby the Bank of Japan got into the rescue effort. At that time they didn't use any of the government's money. It was something similar to what we have been doing with the third world countries' debt problem right now. In fact, in this case the securities company came back very strongly, and so we solved it in that way.

So from this experience I imagine that if something were to happen which risked having grave repercussions on the whole of the industry, probably our authorities, including the Bank of Japan, may feel that they should do something about it. So this doctrine may be prevailing.

But as far as we are concerned, we don't feel that we need that sort of protection, and whatever we do is our doing and we are capable of taking the full consequences of what we have done.

Senator BRYAN. Let me just start again with you, Mr. Kusukawa, if I can and come down the table again.

In assessing what the premium structure is or the levy, which I believe was Mr. Leslie's term, that is, what the cost of financing the deposit insurance system is, is it based upon a flat dollar deposit or is there a risk analysis that this particular bank, and I realize you have far fewer banks than we do in this country? Tell me how the formula is developed.

Mr. KUSUKAWA. It is not that complicated. The rate of our deposit insurance premium is currently set at 0.012 percent, I believe, of the deposits of the bank. So risk analysis doesn't have any bearing on the amount of the premium payment.

Senator BRYAN. It would be a flat fee structure.

Mr. KUSUKAWA. A flat fee structure, yes.

Senator BRYAN. Mr. Cartellieri.

Mr. CARTELLIERI. If our system fees are collected in proportion to the deposits. Presently from the private banking sector 0.03 percent of deposits are regularly on an annual basis collected by the fund.

Senator **Bryan**. Without in any way casting aspersions on the system that you have, presumably some banks are stronger than other banks. Is there any differential in terms of the assessment or the fee that is——

Mr. **Cartellieri**. Not at the present time, and I underline not at the present time.

Senator **Bryan**. Are you suggesting that perhaps that is on the table for discussion prospectively in your country?

Mr. **Cartellieri**. Well, there are people, including myself, who are strongly advocating a change towards that end, yes.

Senator **Bryan**. Thank you.

Mr. Leslie.

Mr. **Leslie**. There is a straight levy based on percentage of deposits. There is no distinction in the nature of the organization being covered.

Senator **Bryan**. Mr. Leslie, let me move down to the table starting with you gain.

Each of you have kind of described a system that I understand that whatever the limits you have, it is a per person, per deposit, if I'm using a term that you're familiar with, and I see my time has expired——

The **Chairman**. No, please take your time.

Senator **Bryan**. If the chairman will permit me just to finish up this question because this is an issue that will be a raging debate in this committee next year as we approach deposit reform in this country.

But if it's a per deposit or per individual system, my question is with all of the sophistication out there in the marketplace with the way money can glide in and out with the way you can broker and package funds in which you can have various family members each individually depositing, but in effect it is a cumulative deposit that exceeds your limit, what type of mechanism, if any, have you set up to control that, or is that something you try to do?

Mr. **Leslie**. Starting with the United Kingdom, the system is restricted, as you say, to that. We undoubtedly have quite a number of arguments in the comparatively few cases where we actually had to start paying out, and those have usually turned on, yes, but it was actually two people's deposits, and it's a question of whether it's a joint account or whether part of the funds were held for another member of the family. But so far those have not proved a real problem.

Senator **Bryan**. Mr. Leslie, if I might followup, and I want each of the other two to respond to this as well. Do you have a concept such as broker deposits where in effect vast funds are infused into the financial system and packaged in a $100,000 increments in this country which, as you know, is our limit, which technically is a per deposit, but in point of fact, it has a far broader impact than that.

Mr. **Leslie**. Not up to now.

Senator **Bryan**. Mr. Cartellieri.

Mr. **Cartellieri**. Nor do we.

Senator **Bryan**. Have you had a difficulty at all in your country in terms of controlling that per deposit? Some of us have been led to believe that that becomes almost an impossible thing to control.

Mr. **Cartellieri**. In practice we haven't had a problem.

Senator **Bryan**. You have not had that.

Mr. **Cartellieri**. No.

Senator **Bryan**. I appreciate that.

Mr. **Kusukawa**. In Japan no, we do not have brokerage of deposits.

Senator **Bryan**. I thank you.

Mr. Chairman, I thank you for your indulgence.

The **Chairman**. Very good.

I want to come back to that broker deposit.

Senator Shelby.

Senator **Shelby**. I just want to followup in one question that I neglected to get into earlier, and this deals with Japan.

The role of the Post Office in the savings scheme in Japan I think is quite large.

Mr. **Kusukawa**. Yes.

Senator **Shelby**. How does that work, and does the Government insure that money or is it impliedly guaranteed because it's part of the Japanese Government. Would you comment on that.

Mr. **Kusukawa**. Yes.

Senator **Shelby**. How large is it in the deposit pool?

Mr. **Kusukawa**. The size of the deposit is 133 trillion yen. So it is very big.

Senator **Shelby**. Say that again.

Mr. **Kusukawa**. 133 trillion yen.

Senator **Shelby**. 133 trillion yen deposited in the Post Office account?

Mr. **Kusukawa**. In the Postal savings system, and this system itself is owned by the Ministry of Post and Telecommunications. So this is a governmental sort of setup. So automatically people look upon this as a government guaranteed deposit.

Senator **Shelby**. Is it express guarantee or implied guarantee?

Mr. **Kusukawa**. Implied.

Senator **Shelby**. Implied guarantee.

Mr. **Kusukawa**. Yes.

Senator **Shelby**. Are most of these savings retail savings?

Mr. **Kusukawa**. That's private, yes.

Senator **Shelby**. Private I mean.

Mr. **Kusukawa**. Yes, retail.

Senator **Shelby**. Now what percentage of the savings in Japan would that constitute roughly.

Mr. **Kusukawa**. Well, just let me see. It will be about 13 percent of the total.

Senator **Shelby**. Thirteen percent of the total savings in Japan is with the Postal savings?

Mr. **Kusukawa**. Yes.

Senator **Shelby**. That is quite high, is it not?

Mr. **Kusukawa**. Yes, it is, indeed.

Senator **Shelby**. And how competitive in a payment of rates that compared to say Fuji Bank?

Mr. **Kusukawa**. Well, nowadays it's roughly the same. In the past it wasn't, and that was a problem we had to solve in the past. So we had to make negotiations for harmonization, and finally we came to the present situation.

Senator **Shelby**. Did the Germans have a similar situation?

Mr. **Cartellieri**. Yes, we have.

Senator **Shelby**. How does it work and what size is it?

Mr. **Cartellieri**. We have a Postal savings system.

Senator **Shelby**. A Postal savings system?

Mr. **Cartellieri**. Yes. Savings deposits at the Post Office are 40 billion Deutsche marks.

Senator **Shelby**. What about the United Kingdom, Mr. Leslie?

Mr. **Leslie**. In the United Kingdom it has become really negligible.

Senator **Shelby**. OK. Thank you.

Mr. Chairman, thank you.

The **Chairman**. You're quite welcome, Senator Shelby.

Coming back a moment ago to the question on broker deposits, one of the things that we have seen develop here with the deregulation of interest rates and the Government deposit insurance, which is the critical element in the puzzle, is that these financial conveyor belts were assembled to collect large amounts of saving and send them around to Government insured institutions that were paying the highest interest rates.

And when you think about it after the fact, you can see how, especially if you've got, in the case of the savings and loan industry, State chartered thrifts with a very broad operating charter.

We found, for example, that in California the State chartered thrifts could have up to 40 percent of their assets in junk bonds, and yet all of that was insured by Federal deposit insurance. I don't think there were probably 25 people in the country that knew it at the time, but it was just one of the flaws that was built into our structure that has come back to haunt us.

In any case, what we saw happen was that these broker deposits were collected in large financial institutions and money centered areas and funneled out on the basis of who was offering the highest interest rates because anybody could offer any interest rate they wanted.

Obviously, all anybody who was running a federally insured institution, had to do to get large amounts of money was to jack up the interest rate and they would attract the deposits, and as a result, that conveyor belt became well developed and a lot of those broker deposits went out there and ended up, as you might expect, with higher interest rates being put in a higher risk profile form of investment.

So you had a situation where the very engineering dynamics of the arrangement, was based on Federal deposit insurance. If you yank that out from underneath, I think the whole thing stops, but that was there. So you had a situation where more and more money was being collected and in a sense being drawn into and put into a higher and higher risk profile of investment.

We actually saw situations that were so extreme that the money conveyor belt people figured out that they didn't just have to do one half of the transaction but that if they were really thinking, they could do both halves of the transaction. They could show up at the door with the broker deposits in the one hand, albeit available at a premium interest rate, and at the same time in the other hand offer a package of investment opportunities, maybe high-risk securities or junk bonds. Then they could say to a Government insured institution in a State that allowed that to go on in the extreme that here we have a $100 million that we'll make available to you at a premium interest rate and, by the way, we also have a $100 million worth of securities that we'll sell you over here offering a much higher interest rate. So if you will pay 10 percent for the deposits, we'll sell you these securities that yield 15 percent and you can keep the 5 percentage points spread.

Well, that looked awfully attractive to a lot of people, and that whole engine gained a lot of steam coming down through the 1980's.

I think in hindsight it's a lot easier to understand things when you're looking back sometimes then it is when they are occurring. It's obvious that what caused that kind of systemic defect was this unlimited deposit insurance these broker deposits, and also this unlimited risk profile.

My sense of what happens is that if you get too far out into that area, you in fact do overwhelm your regulatory system. If you've got competent regulators and lots of them and honest accountants and well intentioned and honest boards of directors and operating executives and companies and so forth, you still may have too big a task to be able to monitor it on a real time basis and you may wake up one day and find that you've gone way over the edge and there is a half a trillion bill outstanding that has got to be paid off over the next 30 years.

That has been the experience that we have just been through and are in the midst of with respect to this very powerful illustration of what took place in the savings and loan system.

But some of the same arguments, albeit under different arrangements, are being advanced here. So it comes back to several of these basic elements, namely, deposit insurance. Does the Government stand behind all this and, if so, in an unlimited fashion, and, No. 2, do we allow broker deposits.

Now it's interesting you don't have broker deposits, as I understand, in any of your 3 countries. Now you're doing away with interest rate ceilings and regulations, but you don't have interest rate ceilings in your two countries.

Now why would it be that broker deposits would not have sprung up in your country, in your view?

Mr. KUSUKAWA. Can I speak about this?

The CHAIRMAN. Yes, please.

Mr. KUSUKAWA. Well, not in this connection, but in the past, in order to promote savings, we had special treatment for exempting the withholding tax on the interest to be paid on savings. We have abolished this treatment because we now have too high a savings rate. But when we had this treatment, the limit for the tax exemption was three million yen. So if you had 10 million yen, you would naturally want to split that among different family members. If you had only three family members, you got up to 9 million yen. As to the other 1 million yen, probably that would be put in the name of a pet dog or cat. [Laughter.]

Well, we had indeed the splitting of deposits as I just said. This was with the intent on the part of depositors to take advantage of a regulatory loophole, but our tax people were very industrious and they got onto it.

The **Chairman**. I see.

Mr. **Kusukawa**. So, we have had a similar sort of symptom in our society.

The **Chairman**. Did either of the other two of you want to respond to that?

Yes, Mr. Cartellieri.

Mr. **Cartellieri**. I think, No. 1, we have no broker deposits in our country because the banks perform the broker function themselves that is a major deterrent and, No. 2, it could have developed towards a similar syndrome if we had money market funds in our country, which we don't, not on the domestic scene mainly because our Central Bank makes a practical impediment in making them subject to minimum reserve and thereby they would be uncompetitive. The Bundesbank is not willing——

The **Chairman**. Should we be doing that here? I mean it's a big question, and I'm not asking you to sit as a legislator here, but I'm wondering if that is a question that we ought to frameup and take a look at?

Mr. **Cartellieri**. The Bundesbank sees the minimum reserve policy as part of its monetary policy. It's a side effect that this way no money market funds can develop, but the Bundesbank has been known to be concerned about the possible development in the change of savings patterns of the population at large by turning savings towards money accumulators like money market funds and others. It hasn't happened so far, but there is a question mark hanging over the development when we look at the development in the United States.

The **Chairman**. Mr. Leslie.

Mr. **Leslie**. I think in the United Kingdom the problem really hasn't arisen because the deposit protection scheme is not really seen yet as something that is an important protection, and therefore it is not worth seeking that protection because it is a very recent system.

Where are seeing the emergence of some brokered funds are much more in the mutual funds borderline area and in the offshore funds borderline area, and that has already caused the regulators a certain amount of problems.

The **Chairman**. Let me just ask one other related question to this, and it's a somewhat perhaps more subtle question or point, a little more arcane point.

If you didn't have deposit insurance such as we have in the United States and savers wanted to have an absolute guarantee, and let's leave aside the certainty of a private insurance fund for the moment, They would presumably buy Government bonds instead of putting their money in a savings form in a insured deposit institution.

Now in a sense, your Postal savings system, I suppose, is sort of a Government bond equivalent. We sell Government bonds in various forms and denominations almost all the time, and there is an open market where people can buy them. They are a little complicated to figure out the first one or two times, but they exist, and presumably anybody who wants an absolute guarantee of the Government can buy a Government instrument of some maturity and get an interest rate. That would be another way to do it.

Let's say we made that change, just hypothetically, and you had a major disintermediation where an awful lot of the savings went out of Federal insured institutions and that block of capital went over into Government instruments, what are the kinds of implications that might flow from that? In other words, when you think about some kind of a change like that, what would you attach to it? What would be the kinds of consequences that we would have to consider in that event?

Mr. **Leslie**. Well, I suppose the main effect would be that the cycle of funds in the system of course would change dramatically. The public sector would be in excess, the banking system would be having to bid for funds in the market and therefore there would be significantly higher rates. That is all theoretically possible, but I would suspect that there is a very big gap between the smaller institution where people might say it's no longer insured and I dare not leave it there towards quite a wide range of nonetheless pretty large institutions where people still would be comfortable.

So I suspect the flow of funds would not be automatically into the Government. There would be a range of variations. And certainly in our own country, although Government bonds have for tax reasons been popular on occasions, the feeling is that the major banks anyway have never let them down and therefore it has been all right. The shift has always been back to quality when there has been any trouble at the bottom end.

Mr. **Cartellieri**. It's more or less the same in my country, Mr. Chairman.

Mr. **Kusukawa**. Yes, I think that we are also in a similar line as Mr. Leslie said.

The **Chairman**. Let me yield to Senator Heinz.

Senator **Heinz**. No further questions, Mr. Chairman.

The **Chairman**. Senator Shelby.

Senator **Shelby**. Mr. Chairman, I have one last question, and I want to address that to Mr. Cartellieri.

It's my understanding that deposit insurance protection in your country applies to all nonbank deposits up to 30 percent of the liable capital of the bank per depositor; is that correct?

Mr. **Cartellieri**. Quite.

Senator **Shelby**. Thus, in practice is it unlikely that any depositor in your bank or the other German banks would be protected to a level of up to 30 percent of a bank's capital? Would the bank's capital up to 30 percent come into play there, or would it not?

Mr. **Cartellieri**. The minimum capital of the smallest bank allowable under regulations by the Federal Supervisory Office at the present time is 6 million Deutsche marks, which would mean even in such a tiny bank that the individual depositor would be protected with a deposit of up to 1.8 million Deutsche marks.

Senator **Shelby**. In other words, on the cap, where do the resources to makeup such a big ceiling possible come from, the capital of the bank.

Mr. **Cartellieri**. Well, the cap really, Senator, comes from the confidence in the ability of the fund to call——

Senator **Shelby**. Of the particular bank or the banking system?

Mr. **Cartellieri**. The banking system.

Senator **Shelby**. The banking system.

Mr. CARTELLIERI. The fund is an instrument of the banking system, and the confidence is there that the fund will be able to mobilize the funds necessary to stabilize a situation in case of need, as it has in the past.

Senator SHELBY. In Germany do you have what we used to call thrifts here as opposed to banks as an institution?

Mr. CARTELLIERI. Sorry?

Senator SHELBY. In Germany do you have a savings institution that is legally different from an ordinary bank?

Mr. CARTELLIERI. Yes. We have the savings sector, which is part of the public sector. The savings banks, as we call them, are all public sector banks. They are owned and controlled by municipalities——

Senator SHELBY. Like a city.

Mr. CARTELLIERI. Local authorities, cities.

Senator SHELBY. Are these banks small banks?

Mr. CARTELLIERI. They tend to be small. Some of them are fairly large.

Senator SHELBY. What is their role? How is their role defined?

Mr. CARTELLIERI. Well, they are basically universal banks like ourselves, the larger ones in any case, and the smaller ones not to the full extent. But if you look at big city savings banks, say the Savings Bank of the City of Hamburg, which is the largest in the country, that is a fairly large institution.

Senator SHELBY. And they are doing the same thing you are doing, commercial banking?

Mr. CARTELLIERI. Yes. Some of them through their, what we call their own center banks, operate on an international scale.

Senator SHELBY. Were they always doing this, or were they created by law for a different era to do a different thing?

Mr. CARTELLIERI. Well, they were created at a different time for much more limited tasks.

Senator SHELBY. Supervision, in other words.

Mr. CARTELLIERI. Yes, but over the centuries and decades they have grown into modern banking.

Senator SHELBY. By evolution?

Mr. CARTELLIERI. By evolution, yes.

Senator SHELBY. Thank you, Mr. Chairman. That's all I have.

The CHAIRMAN. Thank you very much, Senator Shelby.

There are just two or three more things I hope to raise, and I appreciate your patience at the witness table for such a lengthy time.

The banking charter in the United States would not seem to be as attractive as you might see the banking charters in your own respective countries for reasons that you've all laid out here today. And yet I see international banks coming into the United States and establishing themselves and doing quite well as far as one can tell, and at least in terms of market share and deposits and so forth, we're seeing that profile.

I'm wondering what attracts international banks to come to the United States and set up and do business and seem to be at least on the face of it doing quite well if the banking charter here is somewhat limited and less attractive than it might be other places.

Isn't there a bit of a contradiction there?

Mr. LESLIE. Well, I think I would say, sir, that clearly the United States represents one of the major economic forces in the world, and its flow of funds and its flow of customers and their needs remain a continuing attraction for foreign banks.

We come in and we live obviously, as we should do, with the existing regulatory framework. Very often it does enable us to undertake business for those companies and customers elsewhere, and in our case 70 different countries where we operate around the world. We see it as an absolutely essential strategic area.

I think it has been quite interesting to see how the foreign banks have been diversified and have been changing their strategies in some way. Earlier they did see the retail markets I think in the States as a very attractive possible market. Most of them have now withdrawn from that and concentrate much more on the wholesale and on the borders of the investment banking market.

Mr. CARTELLIERI. I think, Mr. Chairman, with the United States being the most important economy in the world, it follows that any internationally operating international bank has no choice but also to be operative in the United States. To begin with, they are here to serve their own domestic customers who have businesses in the United States. I am, of course, talking of German companies that have been operating in this country for such a long time.

No. 2, however, the United States owns and runs the No. 1 transaction currency in the world, and that also makes it important for international banks to be established in the country of this currency. So I think even if the going is difficult, like in the case of Japan, leading international banks have to be in this place, they will have to try to be competitive in this place.

Mr. KUSUKAWA. Yes, I agree with Mr. Cartellieri and Mr. Leslie that the United States is the most powerful in the economic field, and your currency is a world currency, and you have a so well developed financial market in New York, and so internationally oriented banks have to come here to share the sort of transactions we are doing in the world.

We naturally have come to this country when our people and the industrial companies came over here and we came with them, and we have looked after them. While gradually our business has changed, not only in financing the Japanese subsidiaries, but also in financing the American companies, I think it becomes very important for us to be given the same opportunities as the American banks enjoy.

The CHAIRMAN. Now at the present time, and I appreciate those points, and it seems to me in a sense the points apply for us as well. I mean we need to be established in all of our countries and in other locations as well.

Do you know offhand what percentage of your banking assets say in the United Kingdom would be in the form of non-United Kingdom or international banking interests as opposed to your own direct banking interests?

Mr. LESLIE. In terms of assets we would find ourselves roughly at 50 percent.

The CHAIRMAN. Fifty.

Mr. LESLIE. Because of course significant amounts of Euro-currency operations, which may be handled out of London, are in dollars.

The CHAIRMAN. But as you would see foreign banking asset holdings in the United Kingdom, roughly half?

Mr. LESLIE. Yes, roughly half.

The CHAIRMAN. What would it be in Germany?

Mr. CARTELLIERI. Four-point-six percent of banking business—in terms of assets—is conducted by foreign banks.

Mr. KUSUKAWA. I think that in the case of Japan the banking assets, well, in terms of the asset size, I think the foreign banks have got only 3 percent or so. But if it comes to off-balance sheet transactions, I think the foreign banks have much bigger shares of that.

The CHAIRMAN. One of the things that we are trying to understand and make sense out of is that historically the international banking percentage in the United States was relatively low. It has been climbing quite rapidly. It's up to about 25 percent of assets now here in the United States, and of course no one quite knows just exactly what that means. There are many inferences one draws from it, and it obviously relates too to what kind of trend line you are riding, where you are going, and where will you be 3 or 6 years down the road, et cetera.

At least in the case of your two illustrations, because you have higher percentages, you've had to figure out how to integrate that into your other kinds of national economic policy decisions with respect to monetary policy management and a lot of other things.

Japan is obviously in a somewhat different position because the percentage has been lower, and so it's just in a different category.

The speed with which that change is taking place in the United States is posing a new set of questions and considerations that we're beginning to think more about on a broad basis, and it needs more concentration, partly because we are in a different role. You talk about us having the leading global currency role, generally speaking. So that for other reasons I think causes us to probably have to weigh those questions and think about their implications in new ways. We're beginning to do that, but we've got a lot of new problems to have to think about of which that is just one of many.

Let me ask you this. On May 3, Gerald Corrigan, appeared before our committee, and he strongly opposed the merging of banking and commerce in any arrangement that would even remotely contemplate ownership of financial services holding companies by commercial concerns. I've used a quotation from him, and that is the language that he used.

I noted that on page 11 of your testimony you also indicated that Japan's advisory body to the Ministry of Finance also opposed mixing banking and commerce, among other reasons, because of concerns about conflicts of interest in economic concentration. I'm just wondering if each of you would respond to Mr. Corrigan's expressed concern and what I take to be the concern of Japan's advisory body on this issue and why you would either agree or disagree with that.

Mr. Leslie, why don't we start with you.

Mr. **Leslie**. I think historically, Mr. Chairman, that has never been a natural aspect of banking in the United Kingdom, and I don't think we would see it actually emerging at this stage because I don't see the gap that it would be filling. In most cases it has arisen because of gaps in the market.

So I think certainly we would see, and I think that our authorities would not welcome the idea of that actually emerging in the United Kingdom, but since I think it's very unlikely to, I don't think it's a problem.

Mr. **Cartellieri**. Historically links between industry and banks have been very strong in my country. This dates back to the 19th century, the period of industrialization, when the founders of the commercial banks were founders of industrial establishments as well. There were a lot of cross-links both ways.

But if we look at it today, we find that banks have over time run down their industrial holdings considerably. Today, as I said in my statement, they represent about ½ percent of total capitalization of companies with equity above one million deutsche marks. The trend is towards further divestment of industrial holdings rather than investment if only for political pressures because a concern has been raised in my country, too, about implications of power concentration and things like that.

We have always felt that we can live without industrial holdings, but then we have them. Most of them originated in industrial rescue operations. We undertook one just last year where we had to rescue a major industrial group where all together 65,000 jobs were at stake. We kept that industrial holding 100 percent ownership for one year and resold it then to another industrial interest, and we made it quite clear that we had no interest in holding it.

I suppose it was also for political reasons that we made it clear that from a banking point of view we don't see a necessity to hold industrial properties. We consider them more, if I may say so, Mr. Chairman, as a sort of inherited family silver, and not as an essential to banking business.

If we look at relationships between the banks and their industrial holdings, there are a lot of safeguards to prevent any spillovers one way or other. They have to deliver a so-called report on dependence which has to detail all transactions between a bank and its industrial property if it's considered to be controlling this industrial company, and it has to state clearly if there was any case where transactions were not totally at arms-length and at commercial terms. This report has to be approved by the external auditors in their annual audit report.

Basically, these holdings are only investments that ought to yield a decent return, but they are not a matter of industrial or banking policy.

The **Chairman**. Before I go to Mr. Kusukawa, I want to ask the two of you again a related question, and that is there is great pressure building up in the United States to dismantle Glass-Steagall or alter Glass-Steagall and therefore merge commercial banking and investment banking on some form.

I think the push in that direction and the momentum is now beginning to also start to incorporate the argument on also altering the Bank Holding Company Act which established this dividing line between financial services and commercial companies.

So it may well be, just given the dynamics of this situation, that the two separate arguments become more commingled in the debate.

Just having said that, if one envisioned Citicorp and General Motors merging and Ford and Morgan Stanley and Chase Manhattan getting together and so forth, just in theory, and we're thinking about this in terms of theory of structure and sound structure and so forth, would that kind of combination be of concern to either the two of you in terms of the pluses we would get versus the minuses that might come with it?

Mr. LESLIE. I think in our case, Mr. Chairman, it would certainly be a matter of concern, and I think it would turn very largely, and we have had a number of cases where it has turned on the fit and proper person. The supervisor has got certain powers there to decide whether the nonbank company which is merging or taking over is indeed a fit and proper person. They could actually require the structure of the deal to take a form which did isolate the bank and at least ensure that——

The CHAIRMAN. Well, what would your concern be? What is on the theoretical list of sort of flashing red lights and the dangers that would be accompanied by that kind of a consolidation?

Mr. LESLIE. I think the flashing red light would be that yes, banks do have certain risks inherent in them of a systemic nature which requires them to be controlled and supervised separately. If they were totally merged in a commercial company, then it might well become extremely difficult to maintain that supervision and regulation, and I think it's that that would be the matter of concern.

We have had cases where banks, and in fact we have just had one recently where a bank, a small bank has got into difficulties. It was a subsidiary of a company which got into difficulties, and of course some of the problems flowing between those various companies and the group were responsible for causing part of the trouble.

Mr. CARTELLIERI. I think in my country the concern if such a merger, as you call it, would happen would be mainly one of size and of unqualified power as it is called in the political discussion.

However, on a large scale it has never happened and is unlikely to happen for the regulatory and legal framework would make a merger between a bank and an industrial company more or less impossible. One can own the other, yes. An industrial company could own a bank, and there are a few cases, and vice versa. But regulatory frameworks are so different and the legal framework for both entities is so different that an industrial stock corporation would find it more or less impossible to take virtual management control of a bank other than through its ownership right of sending in members of the Supervisory Board. These members may appoint members of the Board of Management, but no direct control would be possible, and vice versa. The stock corporation law and the banking law and the regulatory framework would more or less prevent that.

The CHAIRMAN. Mr. Kusukawa.

Mr. KUSUKAWA. The discussion we have on the question of article 65 is only between the banking and the securities industries. The commercial and industrial side has not yet come into our mind. So this discussion we're having in Japan is purely between the securities and banking.

On the commercial and industrial side, we do have shareholdings. Banks are permitted to hold the shares of commercial and industrial companies of up to 5 percent. So to that extent, we have something to do with commerce and industry, but the Government is very particular that we shouldn't exercise any influence on these companies. But by virtue of these shareholdings, we have a portfolio, a rather large portfolio, of shareholdings in commercial and industrial companies, and that is one of the reasons why the securities industry may feel that we are not only banks, but also in fact sort of large investment trusts or that sort of thing. So therefore if the banks are just coming into the securities market, then this is too advantageous a situation. So they argue that we've got to have a separate organization and not the true universal banking model. That is the argument we are having right now.

The CHAIRMAN. We have two very interesting anomalies, as I would call them here in the United States where in the last several years we had the development of nonbank banks and we had very major companies, Sears and Roebuck and American Express, which is of course a financial services company of a sort itself, coming around and beginning to create something of a blend of commerce and banking in that fashion. So it has been an anomaly and we haven't resolved it. I mean we sort of see it that way as an anomaly.

Now you have another situation where Ford Motor Company, a very major industrial company, has moved into the savings and loan business in a very major way. Now since that time we have changed the nature of the savings and loan business, and the question of what the future will be and whether or not there will even be a separate savings and loan industry is open partly because we've left the option for an S&L, as we call it, to go over into a bank charter with certain requirements attached to it. But we're seeing some amalgamations occurring sort of around and in the system.

So the question is being posed by market forces, if you will, and by individual entities attempting to try to find some collected forum in which to diversify and be profitable, et cetera.

I take it that you are not seeing much of that same kind of thing then in your own countries, or are you?

Mr. CARTELLIERI. It is happening.

Mr. KUSUKAWA. Yes, it is.

Mr. CARTELLIERI. With a time lag it is happening along the same lines. We have seen the automotive industry establishing now consumer credit banks, we are seeing Department stores establishing their own financial services companies, we are seeing mail order houses establishing their own banks for consumer credit, and a lot of this is happening and the lines between financial and non-financial entities are being blurred in our country as well.

The CHAIRMAN. So it may well be that some of what we are seeing, maybe we just happened to see when we saw it, and you're now seeing it, too. I did hear you say that with respect to car loans being pealed off by the companies. That has happened some time ago here in the United States, and of course that has also happened with commercial paper because all the major companies here now are quite able to go ahead and do their own financing in that fashion.

I think the responses that you just gave me with respect to article 65 were helpful. I wanted to just ask one other related question to you, if I may, Mr. Kusukawa, and that is this.

You state on page 1 of the summary of your larger prepared statement, and I quote. You say that you "expect a basic consensus will be reached this month in Japan in allowing banks and securities companies to engage in each other's business," and I'm compressing this, but you go on to say "but the necessary legislation will most likely not be drafted and implemented until 1992."

You further state on page 16 of your larger statement that it is understood in Japan that in light of EC-92 "that if Japan maintains a fragmented financial system our banks will find competing with universal European banks increasingly difficult."

I'm wondering if you can elaborate on this, and I'm wondering if that means that Japan intends to try to key into what you see happening in EC-92, and it's obviously something the United States has to be thinking about as well.

Mr. KUSUKAWA. It so happens that timing appears to be 1992 for the article 65 and also for the EC-92. It could be sort of a coincidence I think, but the two councils are deliberating these issues, and I think probably towards the end of this month, something will be coming up. But then there is the necessity of amendment of the Banking Act or the Securities and Exchange Act. This will take time. So I think probably it is proper to say that it could be 1992 that we are doing it.

As far as we are concerned, the statement I made, that we really want to be permitted to be a universal bank and do the business as the European banks do, is a sort of description of a present status of ours.

The CHAIRMAN. I appreciate that.

Let me just now conclude by saying to each of you again how much I appreciate, and I know my colleagues appreciate and the Senate as a whole appreciates the time and the effort for you to be here today and to give such meaningful testimony to us.

I would like to be able to submit a limited number of questions to each of you for the record on behalf of colleagues that wanted to come but could not so that we might get your thinking on some points that we have not been able to cover in the time that we had here today.

The CHAIRMAN. We are very grateful for the effort and most appreciative.

Thank you all.

The committee stands in recess.

[The committee adjourned at 12:30 p.m., subject to the call of the Chair.]

[Response to written questions of Senator Riegle follows:]

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TORU KUSUKAWA
DEPUTY PRESIDENT

August 1, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Chairman Riegle:

I was very pleased to have the opportunity to testify before the hearing of the Senate Banking Committee on June 13, 1990.

Attached are my responses to your follow-up questions on June 28, 1990. Please allow me to apologize for the time that it has taken to reply.

If you have any further questions, please do not hesitate to contact me.

Best regards,

Yours sincerely,

TK/ta

(Attachment)

Q.1. When Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, appeared before this Committee on May 3, he urged that we move toward a system of consolidated supervision of any company that has direct or indirect access to the Federal "safety net."

What is the practice in your country on consolidated versus functional regulation? Do you agree with Mr. Corrigan on the need for a consolidated supervisor?

A.1. (i) In Japan, as was touched upon in my submitted statement, there is no such thing as a bank holding company. Rather, financial institutions are fragmented by their functions. Correspondingly, supervision has also adopted an essentially functional approach, but within a regulatory framework that is designed to allow for consolidated supervision as well.

Banks and insurance companies are supervised by the banking bureau of the Ministry of Finance (MOF); securities firms are supervised by the securities bureau of the MOF; and, the international finance activities of financial institutions are supervised by the international finance bureau of the MOF.

In addition, securities activities of banks are supervised by the securities bureau, and the international finance activities of banks are supervised by the international finance bureau. Concurrently, the entire activities of banks, including the securities activities and the international finance activities, are supervised by the banking bureau. Therefore, the Japanese supervisory structure, although essentially "functional" in its approach, also allows for consolidated and centralized supervision.

Shinyo Kinko and Shinyo Kumiai (Credit Cooperatives and Credit Unions), roughly the equivalent of Savings & Loans and Mutual Savings Banks in the United States, are supervised by the local government in which the institution is located. Non-banks, such as individual consumer credit companies, are not regarded as financial institutions and are supervised by the Ministry of International Trade and Industry (MITI).

The Bank of Japan (BOJ) is also responsible for the safety and soundness of the financial industry in Japan. Thus, most financial institutions (specifically, financial institutions with current accounts with the BOJ) are also supervised by the BOJ.

(ii) From the above explanation, it seems that the Japanese financial supervisory structure is similar to that of the U.S. structure. However, the main difference is that the MOF, even though it is divided into three distinct bureaus, singularly has supervisory authority over the majority of financial institutions in Japan. Specifically the MOF has direct supervisory control over banks, insurance companies and securities firms alike.

(iii) In his testimony, Mr. Corrigan addressed the topic of how the United States could develop a more effective and thorough supervisory structure for financial institutions. The U.S. bank holding company structure is very different from the banking structure of Japan, and therefore a different supervisory structure is needed. Under the bank holding company structure that prevails in the United States, I believe it is rational to have a combined approach, under which a supervisory authority supervises the consolidated companies as a whole in addition to other authorities that supervise specialized areas by function. However, in order to avoid double and unfair supervision, I believe it is absolutely essential that close cooperation exist between supervisory authorities.

Q.2. Although Article 65 of Japan's securities law is often compared with America's Glass-Steagall Act, it appears from your testimony that it is less restrictive in that Japanese banks can deal in commercial paper and government and municipal bonds.

Do you think that when the Japanese Government lifts Article 65 restrictions, Japanese banks will be able to move more quickly than American banks to take advantage of the new powers because your law has been less restrictive than ours?

A.2. (i) Article 65 of Japan's Securities Exchange Act was based on the U.S. Glass Steagall Act. I think the degree of separation of the banking and securities businesses is not much different legally between the United States and Japan.

(ii) As I mentioned in my statement, Japanese banks can underwrite/sell commercial paper and municipal securities while they cannot underwrite/sell corporate bonds and mortgage backed securities which U.S. bank holding companies can handle through their securities subsidiaries. On the other hand, while the range of securities transactions permitted to U.S. banks is about the same in Japan, U.S. bank holding companies can not only handle through "Section 20" securities subsidiaries all transactions permitted to Japanese banks, but they can also now engage, through such subsidiaries, in a broad range of securities transactions prohibited to Japanese banks, including the underwriting of all types of debt and equity securities. Therefore, I think that in practice, U.S. banks are a little ahead of Japanese banks in their entry into the securities business.

(iii) The reform of Article 65 is expected to enable Japanese banks to enter into full scale securities activities. If the timing of the reform of Article 65 and the Glass Steagall Act is simultaneous, I believe U.S. banking institutions will realize the benefits more quickly than Japanese banks since U.S. banking institutions now have greater expertise in the securities business due to the activities of their "Section 20" securities subsidiaries.

Q.3. Former Federal Reserve Chairman Paul Volcker stated in a May 24, 1990, speech before the Institute of International Bankers that:

> **"In my judgement, the time has long since come for national legislation permitting the process of geographical rationalization to proceed nationwide. That change, in itself, should significantly help the competitive strength of American banks by facilitating their efforts to achieve the necessary deposit base, to lower costs, and to acquire a critical mass of technological and financial resources."**

Do you agree with Mr. Volcker's assessment on this point? Please explain your answer.

A.3. As I stated in my prepared testimony, I believe geographic restrictions on depository institution expansion is one of the major changes that should be considered to improve U.S. banks' competitiveness, because of the difficulty U.S. banks now have in (i) fully covering capital flows throughout the country and (ii) diversifying their asset portfolios. Although the states have been moving in the direction of permitting more liberal expansion, certain states still prohibit acquisitions by banks from other states. The resulting limitations on geographic expansion by banks in the United States are both arbitrary and inefficient. Therefore, I agree with Mr. Volcker that it would be necessary to permit interstate branching nationwide by federal legislation.

Q.4. In his prepared testimony before the Banking Committee on June 20, 1990, Mr. David Hale, the Chief Economist for Kemper Financial Services, states that:

> "Japanese banks typically belong to larger industrial groups (keiretsu), in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."

Some observers claim the keiretsu structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

A.4. (i) It is important initially to distinguish between financial groupings, which are based on loose internal relationships of the kind that characterize the Fuyo Group (see examples below), and industrial groupings, which are based on specific and agreed manufacturing and sales relationships. Both groupings are called ***keiretsu***. However, industrial groupings function somewhat as vertical production and distribution units which are closely linked, while financial groupings like the Fuyo Group do not dictate the activities of their members. Moreover, the securities of almost all of a financial group's member corporations are publicly listed on stock exchanges, and, subject to the disciplines of public ownership, their managements are wholly independent from the bank and any other member corporations.

The Fuji Bank is a member of the Fuyo Group, one of six financial groupings. The main purpose of the Fuyo Group is to promote mutual understanding among its members about international, and domestic economies and various industries activities. Thus, the Fuyo Group can be characterized as a voluntary association or an informal round-table consisting of the Fuji Bank and its major corporate customers. Specialists in such subjects as politics, economics, and international issues are also invited to address the Group's periodic meetings from time to time.

The Fuyo Group, like the other financial groups, is really quite open and liberal. For example, Hitachi belongs to the Fuyo Group as well as to the Sanwa and DKB Groups. Nissan and Kubota are members of the Fuyo Group while Nissan's main banks are Fuji and the Industrial Bank of Japan and Kubota's main banks are Fuji and Sumitomo.1/ Further, Tonen, which is 50% owned by foreign companies (25% by Exxon and 25% by Mobil), is also a member of the Group.

(ii) Mutual holdings of equity shares are very common in Japan and are not limited to corporations within ***keiretsu*** groups. The Fuji Bank, for example, holds 3% of the equity shares of Asahi Glass (Mitsubishi Group) and Asahi Glass owns 0.8% of the equity shares of the Fuji Bank. Furthermore, in the case of the Fuyo Group, while there are mutual shareholdings, they are not nearly so extensive as Mr. David Hale has stated. In March 1989, the percentage of the mutual holdings within the Group was just 15.3%. This means that the rest of the shares, 84.7%, were held by investors outside the Group. Moreover among the five largest equity holders of the Fuji Bank, three (Daiichi Life Insurance, Nippon Life Insurance and Nippon Steel) were companies outside the Group.

In addition, as of March 1989, the share of loans made by the Fuji Bank to Fuyo Group members accounted for just 9.5% of Group members' total bank borrowings. Stated otherwise, the Fuji Bank's loans to Fuyo Group members accounted for just 2.2% of the Bank's worldwide loans as of March 1989. Moreover, the amount of loans extended by the Fuji Bank to individual group members, in some cases, does not exceed the amount of loans extended to members by other banks.

Finally, there are no director interlocks between the Fuji Bank and other Fuyo Group members. It is true that some ex-Fuji Bankers serve as directors of Group companies, but this practice is not by any means limited to corporations within the Group.

1/ A main bank is a bank that plays a major role in coordinating other banks and supporting borrower corporations. A main bank is thus similar to a lead bank among line banks in the United States.

(iii) It is hard to find any evidence that the functional distinction between bank loans and permanent capital is weak in Japan, as Mr. Hale has testified. In this regard, we note that the average dividend yield on equity holdings is less than 1% in Japan, not including return from capital appreciation, while on bank loans the current yield exceeds 7%.

Contrary to Mr. Hale's assertion, the reason Japanese banks were able to raise large amounts of capital so successfully in the mid- to late 1980's is that both institutional and individual investors increased their equity investments in bank shares. The Tokyo Stock Exchange was bullish at that time about our and other Japanese corporations' future prospects. Bank shares attracted particular attention because the banks had shown steady increases in profit without increasing their bad assets.

(iv) As I noted in my written testimony, I believe the most important factors which influence the international competitiveness of banks are:

(a) the economic performance of a bank's home country;

(b) the nation's financial system; and

(c) the management philosophies of individual banks.

Contrary to what some observes have apparently stated, the financial group system is not an important factor in either the international or domestic competitiveness of Japanese banks. Again, I note that the Fuji Bank's loans to Fuyo Group members account for only 2.2% of Fuji's total loans worldwide. Also, I believe that the reason foreign banks do not want to lend to corporations in Japan is not the existence of the ***keiretsu*** system (i.e., the system does not preclude them from making such loans), but rather the extremely thin margins on which loans to major Japanese corporations must be made by any bank, Japanese or foreign, in the current competitive environment.

BARCLAYS BANK PLC

RESPONSES TO QUESTIONS SUBMITTED TO MR. PETER LESLIE BY THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Q.1 When Mr Corrigan, President of the Federal Reserve Bank of New York, appeared before this Committee on May 3, he urged that we move toward a system of consolidated supervision of any company that has direct or indirect access to the Federal "safety net".

What is the practice in your country on consolidated versus functional regulation? Do you agree with Mr Corrigan on the need for a consolidated supervisor?

A.1 In response to your question, I would prefer to speak in terms of consolidated supervision, rather than regulation. Financial supervision of banking institutions in the UK is indeed principally on a consolidated basis; specifically the Bank of England requires a consolidated balance sheet return and a consolidated supervisory return (the "Q7") on a six-monthly basis. The Bank of England's policy was set out in a statement issued in March 1986, and agreed with the Government, the implementation of which fulfills the UK's obligations under the EEC Consolidated Supervision Directive of June 1983.

The Bank of England decides which parts of a banking group must be consolidated for supervisory purposes. The criteria go beyond pure accounting conventions and include the managerial structure of the group, the relative size of an individual company in relation to the bank, the extent of funding provided by the Bank, and potential calls on or other adverse consequences for the bank arising from the company's activities. The Bank of England may also call for information on companies excluded from the consolidated returns if their position is thought likely to affect the health of the bank. Risk analysis is carried out on both a consolidated and a unconsolidated basis, the latter enabling assessment to be made of the distribution of capital within a group.

If deficiencies or potential problems are revealed in the process of consolidated supervision, then regulatory action can be taken. In the case of a financial conglomerate such as our own, where different parts of the group are subject to different regulatory control, it may fall to another regulator to enforce this. I discussed the lead regulator arrangements made between the Bank of England on the one hand and the regulators authorized under the Financial Services Act on the other in my testimony to the Committee and Appendix I thereto. Such arrangements seem vital to avoid the risks of burdensome regulatory overlap or gaps in coverage. At the international level, the Basle Concordat set down principles of supervisory recognition and co-operation in which consolidation plays an important part.

The distinction I have made between supervision and regulation is important, because regulation of conduct of business in the UK is generally on a functional basis (in contrast with financial supervision). The arguments for this approach are relatively compelling, in terms of ensuring consistent regulation of market practices and fair competition in individual business areas.

Given the generally consolidated, or institutional, approach to financial supervision in the UK, together with the functional approach to conduct of business regulation, there has to be an element of duality in the licensing and authorization process. Thus, for example, the senior executives of the investment banking subsidiary of a bank such as ours will have to be judged "fit and proper" by both the Bank of England and The Securities Association (TSA).

The practical application of the lead regulator concept varies depending on the business conducted by different members of a group. For example, in our own case, Barclays Bank PLC and Barclays Bank Trust Company are exempted from the financial reporting requirements of Investment Management Regulatory Organization (IMRO), of which they are members, as the Bank of England acts as lead regulator. Similarly, Barclays de Zoete Wedd Limited, the investment bank, is exempted from making financial returns to TSA. On the other hand, Barclays de Zoete Wedd Securities Limited does have to meet the financial reporting requirements of TSA, as does Barclays Unicorn Limited (the Unit Trust Manager) those of IMRO.

Turning now to the second part of your question, I think it is evident that we in the UK, and indeed it is probably true to speak of the EEC generally, have already accepted the principle of consolidated supervision. Indeed it is hard to recall any serious dissent, although there are bound to be differences to be resolved in practical application.

If there had been any doubt in our minds as to the validity of consolidated supervision, and I do not think there was, this has been dispelled by the evidence of the recent well publicized collapse of a large financial conglomerate in the UK. In this case, the contagion of major problems in a particular subsidiary rapidly spread to the market's (and regulators') perception of the whole group. This included the banking arm, which we are given to understand was comfortably within its prudential financial parameters and yet has seen its depositors' moneys frozen for several weeks, with the eventual outcome still uncertain.

Q.2 Former Federal Reserve Chairman Paul Volcker stated in a May 24, 1990, speech before the Institute of International Bankers that:

> "In my judgement, the time has long since come for national legislation permitting the process of geographical rationalization to proceed nationwide. That change, in itself, should significantly help the competitive strength of American banks by facilitating their efforts to achieve the necessary deposit base, to lower costs, and to acquire a critical mass of technological and financial resources."

Do you agree with Mr Volcker's assessment on this point? Please explain your answer.

A.2 At the moment, progress towards nationwide banking is proceeding in a piecemeal fashion with individual states taking advantage of their right to allow acquisitions by out-of-state bank holding companies. Only four states, (Hawaii, Kansas, Montana and North Dakota) still lack laws that permit some kind of interstate banking activity. There is, therefore, a general consensus among states for a move in this direction and the process will almost certainly eventually result in effective nationwide banking. While the advantage of the present process is that it allows states the opportunity to move at their own desired pace through regional or national pacts, changes in national legislation would speed the process up, quickly put all banks on a equal footing and may avoid possible distortions and complications inherent when there are many separate arrangements. I do not think it is appropriate to comment on the correct balance between Federal and State powers in this context and this one of the matters of cultural difference to which I alluded in my testimony.

The American economy would, on balance, benefit from a move to nationwide banking, because a sound basis would be formed for the Banking system's performance and profits to improve. Empirical studies suggest that the money center banks would benefit less from economies of scale than from a wider, more stable and possibly lower cost deposit base. As I mentioned in my testimony, regional and local banks would benefit from diversification of their lending portfolios, resulting in a lower level of bank failures from exposure to specialized local economies with a consequent saving to the taxpayer and the deposit insurance scheme. Most evidence suggests consumers of banking services would also benefit from the increase in competition and be better served. The increase in competition need not result in an increase in bank failures either. There is no evidence that small banks cannot compete with large banks; indeed they frequently earn higher returns on assets, but that is a question for individual banks' managements to address.

Q.3 During the June 13 hearing Mr Kusukawa, the Deputy President of the Fuji Bank, told us that the international competitiveness of banks is largely influenced by the overall economic performance of its home country.

Do you agree with this assessment and, if so, how much can we increase the competitiveness of financial institutions through product or geographical expansion or better supervision, if we do not deal with the larger macro-economic factors hindering the overall performance of our economy?

A.3 The overall economic performance of a bank's country of origin is only one of several factors influencing the international competitiveness of banks. The others include management ability, good supervision, enlightened trade and financial policies and flexible regulation. There are many examples, of which the United Kingdom is but one, where the banking industry has been very strong in the international competitive environment, whilst the domestic economy is of moderate scale in the overall international context.

Q.4 In his prepared testimony before the Banking Committee on June 20, 1990, Mr David Hale, the Chief Economist for Kemper Financial Services, states that:

"Japanese banks typically belong to larger industrial groups (Keiretsu), in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker then in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. Firms. In the late 1980s, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."

Some observers claim that the keiretsu structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

A.4 I do not believe it is true to say that belonging to a keiretsu gives a bank an unqualified or necessary advantage. Much depends on the fortunes of the Keiretsu grouping itself, as I would like to explain.

Banks which belong to Keiretsu have three broad classes of customer:

(a) "Own" Keiretsu Members - the companies and the workforce.

(b) "Other" Keiretsu Competitors - the companies, banks and workforce.

(c) the rest of the world.

Looking at each in turn:

(a) "Own" Keiretsu Members.

Keiretsu member banks clearly have an overwhelming advantage over other banks for these customers. The advantage is greatest if your Keiretsu is very large and growing quickly. A small and shrinking Keiretsu is not much of a core customer base.

(b) "Other" Keiretsu Competitors.

The converse of the above applies. It must be difficult to get business from companies which are part of another Keiretsu. The implication of the above observation is that, to some extent, whether or not a bank is successful depends not on its own performance but on the performance of its Keiretsu. Instead of facing a market test of their success as banks they face internal financial targets which are as tough or as soft as their 'Keiretsu' shareholders want.

(c) The rest of the world.

The question here is whether membership of a Keiretsu increases the competitiveness of a bank. There are at least two dimensions to this:

i) Reputation/Recognition.

A bank with the name of Mitsubishi has an advantage over a similar sized bank with a less well known and less prestigious name.

ii) Pricing.

Quite apart from the question of whether other parts of the Keiretsu would subsidize the bank, there is the question of whether membership of a Keiretsu in itself reduces the cost of capital of the bank and therefore enables it to undercut non-Keiretsu competitors. The cost of capital is a very difficult concept to quantify. A simple approach (see Appendix note) does not reveal any significant advantage for motor companies involved in a Keiretsu over motor companies which are not part of a keiretsu.

The overall financial return earned by Japanese banks doe not suggest they enjoy a competitive advantage. Returns on assets of Japanese banks are a fraction of their western counterparts and they rank very poorly in terms of 'real profitability' according to studies by the IBCA, a London-based rating agency. Indeed, it is not uncommon to find Japanese banks making a loss on their traditional banking business, profitability being sustained as a result of non-interest income or extraordinary items such as profits from securities trading.

APPENDIX: ESTIMATING THE COST OF EQUITY CAPITAL FOR JAPANESE MOTOR MANUFACTURERS

Since, in theory at least, today's share price equals the expected value of all future dividend payments it follows from a simple mathematical proof that:-

$$Ke = \frac{D\Phi}{P\Phi} + g$$

Where Pt = Share price at end of period t

Dt = Gross dividend at end of period t

Ke = Company's cost of equity (the discount which equates expected future cash flows and current market prices).

g = Constant growth rate of dividend payments (This has to be approximated using the average arithmetic growth rate in dividends per share over previous years. It should be noted that no single method of approximation will be appropriate in all cases and therefore caution is advised when interpreting the results).

Motor Companies Involved in One of Japan's Eight Major Industrial Groupings	Estimated Cost of Equity March 1990
Mitsubishi (Mitsubishi Group)	3.14%
Toyota (Mitsui and Tokai Groups)	4.50%
Daihatsu (Sanwa Group)	0.73%
Nissan (Fuyo Group)	1.26%
Arithmetic Mean	2.41%

Motor Companies Not Involved in One of Japan's Eight Major Industrial Groupings	Estimated Cost of Equity March 1990
Mazda	0.93%
Honda	4.02%
Hino	5.83%
Suzuki	0.73%
Arithmetic Mean	2.88%

Conclusion

Our estimates do not show an appreciable difference in the cost of equity finance for those Japanese motor manufacturers involved in one of Japan's eight large industrial groupings when compared with those not involved.

Answers given
by
Dr. Ulrich Cartellieri
Member of the Board of Managing Directors of
Deutsche Bank AG

to the questions asked by
Senator Donald W. Riegle, Jr., Chairman
United States Senate Committee
on Banking, Housing and Urban Affairs

August 15, 1990

Q.1.:
When Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, appeared before this Committee on May 3, he urged that we move toward a system of consolidated supervision of any company that has direct or indirect access to the Federal "safety net".
What is the practice in your country on consolidated versus functional regulation? Do you agree with Mr. Corrigan on the need for a consolidated supervisor?

A.1.:
The American system of separation between commercial banking and investment banking is not known to the German banking system. About 95% of all German banks are so-called universal banks which are entitled to - and often do - engage, within the same entity, in an almost unlimited scope of activities. These include among others commercial banking, securities-related business, investment advice, factoring, leasing, real estate activities. The regulation and supervision of banks in Germany, both on the level of the individual bank and that of the banking group as a whole, is centralized and exercized on a federal, i.e. nationwide, level. The main supervisory body is the Federal Supervisory Office which supervises all activities performed by the individual banks, including the universal banks with their respective commercial banking and investment banking activities. At the same time, the Supervisory Office controls compliance with the consolidation requirements on the group level. Since all of the parent (holding) companies of the German

banking groups are banking institutions themselves, they are subject to banking supervision and regulation both on the individual and the consolidated level. In essence, the very structure of the German banking system and the supervisory system automatically ensures consolidated supervision.

I share Mr. Corrigan's views that a move toward a regime of consolidated supervision of a banking or financial group is the preferable solution. If one supervisor is assigned the task of supervising a group of banks and/or security houses, effective supervision is enhanced. This approach allows the consolidated supervisor to assess the activities of the group as a whole, including the activities of the parent company and the interrelationship between the various group members in the appropriate manner.

If the dominant company of a group is a bank, which has access to the public "safety net", it clearly makes sense to have such group as a whole supervised by the supervisor in charge of banking supervision - even though the parent may not be a bank. While the problem of deciding between a functional and a consolidated approach to supervision does not pose itself in Germany, which has a centralized system of supervision, the situation in the United States seems to be rather clear cut as both approaches can be combined. Consolidated supervision would be exercized by one supervisor at the group level, while the current regime of functional supervision, exercized by a variety of supervisors, would remain in place with regard to the activities of individual group members.

Q. 2:
Some commentators on the E.C.'s Second Banking Directive contend that it will result in a convergence in a single model of major banking institutions within the Community. Mr. Leslie states a contrary view on page 28 of his prepared testimony noting that it is "more likely that banks will become increasingly dissimilar as they seek competitive advantage in a fragmented marketplace".
What are your own views on the issue of whether the major institutes within the E.C. will converge to a single model?

A. 2:
Once the single EC financial market is completed, it will be the largest and most liberal financial market in the world. Three direct effects can be expected from this:

a) Competition will intensify;

b) The innovation process will concentrate on new products, new organizational forms, and new distribution channels;

c) Europe will become even more attractive for banks from non-EC countries because of the far-reaching business opportunities there.

For the banks, "Europe 1992" symbolizes a monetary unification process, which is to be developed through the following stages:

a) A uniform financial market without internal borders: All capital controls had to be dismantled by the middle of this year.

b) A single banking market without regulatory borders: In the future, financial institutions will be able to operate on an EC-wide level under the same conditions. A bank license from one EC member state will entitle an institution to operate either on a cross-border basis or by establishing its own branch network throughout the EC. Regulation and supervision will be carried out by the licensing country and will be recognized in all other EC states.

c) A single currency zone with a Euro-Fed and a European currency: Later this year, an inter-governmental conference is to work on amendments to the Treaty of Rome necessary to establish a European Monetary Union.

The mutual recognition of banking licenses and supervisory measures in the individual EC states presupposes a minimum of common standards. Consensus has developed on the definition of equity capital and a solvability coefficient, a ratio of equity capital and a bank's risk business volume. There is also consensus on the necessity of exposure limits for large-scale loans and of limiting regulations related to the entire range of services offered by a universal bank. While less stringent provisions are planned for investment banks, universal banks are expected to be free to apply these lesser standards to their own investment banking business as well.

Europe will have a single financial market, but no uniform banking system. There are, however, clear signs of convergence in the field of banking regulation. In the single market, with its harmonized regulation, its freedom to establish branches and no administrative firewalls between different banking sectors, there will be ample space for various forms of financial institutions to compete, including universal and specialized banks. Under these competitive pressures, we expect a growing number of institutions to take their business in new directions both in financial and non-financial areas. Only a limited number of institutions, however, will have the skills and financial strength needed for operating on a Europe-wide scale. More institutions will therefore concentrate on specific business sectors, customer groups, or regions.

Q. 3:
Former Federal Reserve Chairman Paul Volcker stated in a May 24, 1990, speech before the Institute of International Bankers that: "In my judgment, the time has long since come for national legislation permitting the process of geographical rationalization to proceed nationwide. That change, in itself, should significantly help the competitive strength of American banks by facilitating their efforts to achieve the necessary deposit base, to lower costs, and to acquire a critical mass of technological and financial resources."
Do you agree with Mr. Volcker's assessment on this point? Please explain your answer.

A.3:
Yes, I agree with Mr. Volcker's assessment. I think that the progressive erosion of the McFadden Act should contribute to a strengthening of U.S. financial institutions, because it promotes their regional broadening and thus makes them larger and more stable banks. Such broader-based banks should be better positioned to compete with each other and in the international arena. Having said that, one needs to realize at the same time that even the outright abolition of the McFadden Act would not result in a situation where all banks would engage in nationwide banking. A large number of the successful regional banks will either use this newly gained freedom not at all or do so only sparingly in carefully selected segments of the market. On the whole, though, the abolition of the McFadden Act would reestablish vital parameters of competition for U.S. financial institutions as it would make the option available to them to expand and to diversify regionally. This will allow U.S. institutions to build a strong home base for their international operations and abolish a respective disadvantage with regard to their international competitors.

This option concerning the availability of a strong home base with regard to a bank's international strategy is all the more important for U.S. institutions at a time when national boundaries increasingly lose their importance in Europe. The European single market brings about a financial market similar in size to that of the United States. The regulatory system guiding that market will be more liberal and more advanced than that of the United States (see also the answer to Question 2). A growing number of Europe's financial institutions already considers the European Community as their home base for the near future. They obviously expect substantial advantages for their operations from unrestricted EC-wide banking.

Q. 4:
During the June 13 hearing Mr. Kusukawā, the Deputy President of the Fuji Bank, told us that the international competitiveness of banks is largely influenced by the overall economic performance of its home country.
Do you agree with his assessment and if so how much can we increase the competitiveness of American financial institutions through product or geographical expansion or better supervision if we do not deal with the larger macro-economic factors hindering the overall performance of our economy?

A. 4:
The overall economic performance of the home country is obviously important. But when it comes to assessing the international competitiveness of financial institutions, it is only one factor among others. Other relevant factors are issues such as strategy, the quality of management, and the degree of internationalization. This is borne out by the fact that even in times when the overall economic performance of a country - say, France, Germany, or Great Britain - was not exactly free from trouble, these countries nevertheless were the home of banks that were very competitive in international markets. By the same token, good performance in the domestic economy by itself is no guarantee for the success of banking institutions, be it at home or abroad. A bank's success depends first and foremost on its own performance as well as on the regulatory environment in which it operates. Macroeconomic factors such as the country's overall economic performance are only of secondary importance.
Therefore, the key issue is the optimization of the banks' regulatory environment. Two aspects warrant special attention in this regard:

a) The separation erected between the investment banking and the commercial banking side of the business and the prevention of nationwide banking no longer serve useful purposes in today's world. The rationale put forth in the 1930's when these measures were introduced - that is, the avoidance of another severe crisis in the banking system - provides no sufficient justification. The advantages of nationwide banking have already been addressed (see Question 3). With regard to the advantages of a universal banking system, the following features stand out: Banks can operate on the basis of a highly diversified balance sheet. Risk concentration is substantially lower than in a system with mandatory specialized banks. Lower profits or losses in one sector may be compensated by higher profits in another field. A comparison of earnings trends appears to confirm that the broad range of activities pursued by universal banks not only spreads the risk, but also stabilizes earnings considerably.

Furthermore, the diversification of risks and the relative stability of earnings of universal banks are key factors in the stability of the entire banking system. By the same token, there is a much lower risk of calls on the deposit insurance system.

A key function for regulatory authorities should then be to ensure that no new competitive distortions arise to the detriment of either type of bank, be it specialized or universal. The development of form and structure of the financial institutions should be left to the market.

b) The second area worthy of reform is the deposit insurance system. It should be structured in such a manner that, first, it will not impede the ongoing evolution of the financial industry (i.e., the reduction of current overcapacities); second, it should not create any signals that mislead the market forces. This would, for example, be the case if losses incurred can simply be passed on to the taxpayer, or if deposits and investments made with a specific institution appear to be virtually risk-free because of insurance schemes which do not require the depositor to consider more closely the often substantial differences in various banks' credit ratings.

Q. 5:
In his prepared testimony before the Banking Committee on June 20, 1990, Mr. David Hale, the Chief Economist for Kemper Financial Services, states that: "Japanese banks typically belong to larger industrial groups (keiretsu), in which they have extensive cross-shareholdings. As a result, the functional distinction between bank loans and permanent capital is muchweaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."
Some observers claim the keiretsu structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

A. 5:
Yes, I largely agree with that assessment. The Japanese economy is dominated by between 80 and 100 keiretsu; they are conglomerates composed of a large number of businesses of various kinds. Their internal cohesion is ensured not by means of any formal holding-type structure, but through cross-shareholdings, which are often rather insignificant in size, and through an institutionalized consultative mechanism. The core of these conglomerates is usually made up of a bank and/or a trading company. The typical role of the banks is to finance the activities of other keiretsu companies as well as, in many cases, the formulation of the entire group's strategy. Decisions reached in the Council of Presidents are binding for all constituent parts of the conglomerate. These structures present foreign banks with some hurdles in terms of access to the Japanese market. Put differently, Japanese banks are afforded a singularly strong home base. This home base, in turn, enhances the leeway of Japanese institutions in the international financial markets. The latter provide Japanese banks with opportunities for expansion that are much greater than those in the home market which is divided up along predetermined spheres of influence.

The keiretsu structures, though, also have certain disadvantages from the point of view of Japanese banks. These concern mainly the risks to which Japanese banks are exposed with regard to the business activities of other members of the group. There have been cases where the group bank had to cover extensive losses incurred by another part of the keiretsu. Up to now, the banks have always stood by their informal obligation to cover such losses. Therefore, the price a keiretsu's core bank has to pay for a secure market base is insecurity in terms of risk-sharing. This fact also explains why Japanese banks are keen on participating in the formulation of company and group strategies.

On balance, the keiretsu structure appears to provide Japanese banks with a considerable competitive advantage but at a certain price. Group loyalty will always make certain that the group bank will be preferred over non-group and foreign banks. The aforementioned liability risk has the built-in advantage that Japanese banks attach the utmost importance to the financial and consulting services they provide to the other keiretsu companies. These companies benefit from those services not only in terms of their internal financial management, but also with regard to acquisitions and activities in the field of foreign direct investment. Even assuming that foreign banks could operate under conditions similar to those under which Japanese banks operate at present, it remains very much an open question whether foreign banks would be willing to enter into such close relationships with non-banks as their Japanese competitors are obviously prepared to do.

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

WEDNESDAY, JUNE 20, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Pressler, Dixon, D'Amato, and Bryan.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance, and very particularly our distinguished witnesses today who have been gracious enough to travel some distance to join us and to help us with the inquiry we have under way here.

Today the Banking Committee is holding the 9th in a series of 13 hearings on deposit insurance reform and financial services modernization.

In April we heard from representatives of the American banking, securities, real estate and insurance industries. In May our hearings focused on various proposals developed by academic and other experts to reform our deposit insurance system.

In May we also heard from Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, regarding his views on why deposit insurance reform and modernization of our financial system are needed.

Last week we held the first of three hearings this month designed to give the committee a better understanding of financial service developments and trends in other major financial centers and their potential impact on the competitiveness of U.S. financial institutions both abroad and in our domestic market.

At last week's hearing we heard from Toru Kusukawa, the Deputy President of Japan's Fuji Bank, who told us that he believed that Japan would reach a consensus agreement this month to remove barriers separating the banking and securities industry in that country by 1992.

He explained that, in his opinion, Japan was developing such consensus because it realized that if Japan maintained a fragmented financial system, its banks would find it more difficult to compete with the larger universal European banks being made possible by Europe 1992.

There have since been some stories in the press that sound as if things may not be fitting together quite so neatly in Japan, and so we'll have to see what future events bring on that front, but, nevertheless, that was his testimony to us.

And, in the near future, Treasury Secretary Brady will come before us to give us the administration's view of financial developments in Europe and Japan and what they mean for the competitiveness of our financial institutions and markets.

So the committee is pleased to welcome today three very distinguished witnesses with extensive expertise on international financial developments.

Mr. Peter Cooke, now with Price Waterhouse in London, had a long career with the Bank of England and Chaired the Ten National Bank of International Settlement Supervisory Committee, which developed the Basle international capital standards.

Mr. Jeffrey Chisholm is Vice Chairman of the Bank of Montreal, one of the 10 largest banks in North America, which has extensive operations in Canada and the United States.

Mr. David Hale, the Chief Economist for Kemper Financial Services, is a noted expert on Japan's financial services system.

Each of today's witnesses has been asked to discuss the following items as they regard to his own country: Financial activities permissible for its banks; its bank regulatory organization and supervisory practices; and its system of deposit insurance, including its attitude toward the too-big-to-fail issue among others.

We have also asked each witness to give us his vision of how the financial services industry will evolve over the next several years and to advise us what trends and developments we should be most aware and cognizant of in considering how to modernize our own nation's financial system.

So, again, I want to thank our witnesses for coming, and let me now yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Today the committee continues its review of the international dimensions of the financial modernization issue. The deregulation debate in the past has always focused on what types of financial services should be permitted for our banks purely as a domestic matter.

Increasingly the challenge facing our banks and other financial service companies, both in our home market and abroad, is coming from international competitors organized and financed very differently from our own institutions.

Last week we heard from British and German bankers about their plans to offer a full range of financial services throughout Europe providing a solid base for international competition.

We heard from Fuji Bank how Japan is responding to the European challenge by moving to a similar model of universal nationwide banking within the next 2 years.

Today we will hear that Canada pursues the same policy. As one who has long favored changes in United States financial regulation, I believe the message of these hearings is clear. The other major financial centers have seen that real financial strength comes from diversification of risk across geographic and product boundaries.

As we move forward with financial deregulation in the coming year, I hope that we respond to the increasing competitive pressure from beyond our borders. Unless we do, we will see the United States in world markets for our financial services dominated by banks from Europe, Japan, Canada and elsewhere where large diversified financial service companies are becoming the norm.

Gentlemen, we welcome you here today, and thank you for your willingness to testify.

The CHAIRMAN. I might say as well that we have legislation on the floor right now that is a matter of great interest to a number of members of the committee, and so several are tied up there and will come and go, and they are able to do so.

Mr. Cooke, we would be pleased now to hear from you. We'll make your full statement a part of the record, and any summary comments you want to make we would like to have at this time.

STATEMENT OF W. PETER COOKE, CHAIRMAN, WORLD REGULATORY ADVISORY PRACTICE, PRICE WATERHOUSE, LONDON, ENGLAND

Mr. COOKE. Thank you very much, Mr. Chairman and Senator Garn.

My name is Peter Cooke, and I am presently the Chairman of the World Regulatory Advisory Practice of the international accounting firm of Price Waterhouse. Previously I worked for 33 years with the Bank of England. I was head of banking supervision from 1976 to 1985 and chairman of the Basle committee of bank supervisors of the G–10 major industrialized countries which meets at the Bank for International Settlements in Switzerland from 1977 to 1988.

I very much appreciate your invitation to testify this morning on the subject of global financial service trends and developments.

The CHAIRMAN. I might just say, if I may interrupt, and I should have said it a minute ago. We are really breaking new ground here with our hearing process in inviting international perspectives, and I think it is a measure of the globalization process that is underway, and therefore it carries a significance beyond just a given hearing on a given day on this particular topic.

Our witnesses at our last hearing also were bringing an international perspective, and I think in a sense it's very much a measure of how times have changed that we really now must think and understand things on a global basis.

So I just want to preface your comments by saying that because we are making some history by virtue of the fact that we are now attempting to think and reason and work within our legislative process and in our thought process across these international boundary lines.

Mr. Cooke. I hope, Mr. Chairman, what I have to say will be consistent with your comments.

I would like to summarize very briefly some of the main issues that I have covered in my paper. I do this from my perspective as a former regulator and now a regulator watcher.

The present system of financial services regulation has grown out of the domestic environment in this country more than perhaps in most, but I would suggest any major review needs to take carefully into account the international environment also.

Financial market integration proceeds apace and no country can be an island. As an Englishman I have to say that to myself from time-to-time.

All countries are learning from the experiences of others and developing varying degrees of consensus on new regulatory practices and frameworks. The organization of the financial services industry I would suggest has four imperatives. There may be more, but I have identified four.

It should set out to ensure systemic soundness, and within that the soundness of individual institutions.

It should provide reasonable protection for the users of its services.

It should permit the providers of those services to develop their business flexibly and responsibly over time to meet their customers' needs and at a reasonable cost.

And, as I just mentioned, it needs to be responsive to the international financial environment.

Fulfilling all these imperatives of course requires some compromise on each of them, and the balance must be right, but I would note five factors currently present where the design of the U.S. domestic structure, aimed primarily at the first two imperatives—systemic soundness and consumer protection broadly stated—is affecting the international competitiveness of U.S. banking and financial services businesses.

These factors are not at all original, and I list them rather briefly.

First, the Glass-Steagall barrier limits the ability of corporations to provide the full range of banking and investment services which major corporate customers increasingly look for around the world. U.S. banks must be at a disadvantage in developing a multi-faceted global strategic thrust when they are constrained at home from doing what they can do abroad.

Second, and leading on from this, they also find it more difficult I believe to develop the range of senior management skills and experiences necessary to control effectively a major diversified worldwide business.

Third, the risks tend to be too concentrated because of constraints in achieving a wide spread of business geographically and product-wise.

Fourth, an overbanked, perhaps still overbanked, domestic market also impairs profitability.

And, finally, the multiplicity of regulatory authorities, Federal and State, adds to the costs and I believe diminishes the effectiveness of regulation.

Now you've asked me particularly to comment on the scene in Europe. In brief, I believe the movement towards the creation of a single market as large as that of the United States has to be taken very seriously and particularly in the financial services area where more progress is being made than in many other areas in the community.

There are many technical difficulties to be overcome and a greater growing together of national systems is still needed, which cannot be rushed too much, but in the fields of banking investment services and insurance progress is being made, particularly in banking.

The end of 1992 may not be a magic date when financial markets will be comprehensively unified, but it will continue to be a spur to closer coordination and further effort.

Structurally, the universal banking concept, whether of the German variety (with the range of businesses being undertaken within one legal entity) or the English variety (where a range of financial services are provided in a linked group of companies) is running strongly. But it presents a range of regulatory problems, of regulatory overlap, conflicts of regulatory jurisdictions and the problem of whether the regulatory framework should be one based on a functional or institutional approach. But it is clearly the way the markets want to go.

The European community framework, however, does *not* set out to mandate one particular structure. It permits many. I suspect, however, that regulatory problems particularly may encourage the authorities and perhaps even the practitioners toward the group model. In the next years, however, the European market will continue to meet a wide range of customer needs through different institutional structures.

Major cross-border and cross-industry links in Europe are not coming about fast in anticipation of 1992. Cautious informal links are being made cross-border and some modest participations in other institutions. Banks and insurance businesses are also coming together here and there, but there have not yet been major steps to rationalize and integrate.

United States and Japanese banks and other financial service businesses are relatively conspicuous by their absence in making major plays currently in Europe. Maybe strong moves will come in a rush further down the road.

But of one thing I am fairly confident. I do not believe that the European Community will discriminate seriously against institutions from soundly regulated countries outside. Europe has far too much to lose to erect barriers unilaterally for non-EC businesses simply in order to keep out competition.

The barriers between banking and commerce in Europe tend to be handled through the supervisory process rather than by applying legal barriers to any mixture of the two. There are some limitations on the degree of participation permitted by banks or nonbanks or ownership of banks by single commercial enterprises.

The problem determining the appropriate boundaries between banking or financial businesses on the one hand and commerce on the other is one which many countries are wrestling with currently.

The important thing, in my view, is that if it is allowed to happen rather freely, then there is an important onus on ongoing supervision to ensure that these institutions do not operate to the detriment of a sound system or of the users of financial services.

Mr. Chairman, in my statement I have summarized very briefly the European approach to deposit protection, and I don't intend to review that in detail, and I really draw few conclusions beyond noting the diversity of the schemes that actually exist in the different European countries and to say that they are all relatively new, certainly compared with the U.S. tradition, and largely responsive to consumerist pressures and aimed at the smaller depositor.

In a few countries, including my own, efforts have been made to ensure the principle of caveat emptor continues to play some part by an absence of total protection.

Mr. Chairman, I would like to conclude these brief comments with one particular thought. Looking forward through the 1990's I believe that, in a global market, it is going to be very important both for systemic soundness and for a reasonably level playing field that financial businesses around the world, and the regulatory systems, should be set in broadly similar molds, and most particularly in the major industrialized countries' markets, specifically in the European Community, in the United States and in Japan.

Regulatory cooperation among banking supervisors is now well established. Efforts are currently underway to improve cooperation in the capital markets' and investment business areas. I believe it is also now time to look at some similar effort toward closer cooperation among the insurance regulators.

In the narrow field of capital adequacy much has been achieved to make the regime for banks in these three major marketplaces broadly similar. I believe this convergence or at least coordination will need to be an objective in other aspects of the regulatory system. The trend globally is moving in favor of universal banking models, although not as an exclusive model.

The debate in the United States and in Japan is taking account of this, but there are a range of structural issues where the need for some reasonable compatibility, but not necessarily uniformity, between the major international players will be needed on issues like boundaries between banking and commerce, the mix of banking and capital markets' business, banking and insurance and the appropriateness and effectiveness of fire walls and Chinese walls. Some consistency of approach seems to me to be highly desirable.

With the current momentum toward 1992, Europe is becoming a market leader in some areas. I hope the United States authorities will feel it is right to keep alongside developments in Europe and participate fully in the wider debate. This I believe would be for the wider and general good of all concerned.

Thank you, Mr. Chairman.

[The complete prepared statement of W. Peter Cooke follows:]

STATEMENT

BY

PETER COOKE

CHAIRMAN

WORLD REGULATORY ADVISORY PRACTICE

PRICE WATERHOUSE

TO

THE UNITED STATES SENATE COMMITTEE ON

BANKING, HOUSING AND URBAN AFFAIRS

20 JUNE 1990

SUMMARY

This statement addresses the following issues:-

1 The US system of financial regulation

The present US system of financial services regulation has grown out of the domestic environment but any review needs to take carefully into account the international environment also.

The international competitiveness of US banking and financial services businesses is affected by the domestic structure because of

(i) the Glass Steagall barriers between banking and securities businesses;

(ii) the consequent difficulties for US based senior management to develop the range of skills and experience relevant to a global financial services business;

(iii) the tendency for risk to be too concentrated because of domestic geographical constraints;

(iv) an overbanked domestic market which impairs profitability;

(v) a multiplicity of regulators.

2 The European Community scene

The movement toward a single market in financial services at the end of 1992 is making progress. Banking coordination is ahead of securities market coordination. Insurance business integration is lagging some way behind.

The system being put in place for banks does not mandate any particular banking structure (eg universal banking on the German model). Rather it accommodates a range of structures. Some factors, particularly regulatory considerations, may over time favour the 'English' model of universal banking, where a full range of financial service business, conducted in a range of companies grouped under a holding company, becomes a preferred structure.

But the financial market in Europe will continue for many years to see a great variety of corporate structures, types of financial supermarkets and niche businesses, as would be expected in a large and mature marketplace. Cross border links within Europe will grow, but maybe not particularly fast. The policy of national treatment and effective market access should mean that non-European Community financial businesses should not be significantly disadvantaged in the years ahead. It will be in Europe's interest to maintain a liberal stance in this respect.

3 The mix of banking and commerce

The boundaries here are difficult to define and apply comprehensively: many countries are struggling with problems at present in making clear distinctions between financial and non financial businesses, and whether financial regulation should be on a functional or institutional basis. Establishing clear boundaries is difficult, but the closer the links the more important effective regulation will be.

4 Deposit Insurance

Most, but not all, European countries have over the past 20 years or so introduced deposit protection arrangements designed to protect smaller depositors in the event of bank failures. The different arrangements, particularly in EC countries, are briefly described. They are more consumer protection oriented than designed to underpin the system, but they do make some contribution to the latter objective. The coverage and scope of the schemes vary considerably but the scale of protection afforded is generally less than under the US scheme. Most are officially sponsored and run; some are organised by the banking industry itself. Generally all authorised banks are covered, irrespective of size and range of business.

5 Future trends in global financial services

Globalisation is the main influence on the evolution of international financial services businesses. It will be important that the global structure of regulation of these businesses should be as compatible and consistent as possible in the interest of competitive equality, regulatory effectiveness and market efficiency. All countries looking at their local regimes should bear in mind this global dimension - but especially the United States. Internationally, regulators must continue to coordinate closely in the interests of all. This already happens with banking; it is in prospect for securities businesses; it is likely also to be needed in the insurance sector.

Mr Chairman, members of the Senate Banking Committee.

My name is Peter Cooke and I am presently the Chairman of the World Regulatory Advisory Practice of the international accounting firm, Price Waterhouse. Previously I worked for 33 years in the Bank of England. I was Head of Banking Supervision from 1976 to 1985 and Chairman of the Basle Committee of Bank Supervisors of the G10 major industrialised countries* which meets at the Bank for International Settlements in Switzerland from 1977 to 1988. I very much appreciate your invitation to testify before you on the subject of global financial services trends and developments.

You have asked me to address a number of issues relating to the state of different banking systems, the structure of financial institutions, their relative competitiveness and the protection to be afforded to the users of financial services. To undertake this in any comprehensive way would require encyclopaedic knowledge and a depth and scope to the analysis which I am not in a position to undertake. Also I know you have received much expert testimony already from many individuals and organisations better qualified and equipped to provide you with substantive basic material than I am, so perhaps a slimmer volume of evidence than usual will be welcome to you. I should also stress that the views expressed are my personal views.

1 The current system of regulation of financial services business in the United States

Over the years I have learnt to be cautious about making invidious comparisons of particular aspects of a national regulatory system. Each one is a product of a long period of historical evolution during which it has absorbed and reflects a range of particular national circumstances stemming from the developments of a country's economy, law, culture and psychology. So the system in my own country, the United Kingdom, has grown up out of the 19th Century preeminence of sterling and the role of London as an international financial centre. The regulatory framework has evolved within the market, much of it originally based on the principle of self-regulation by the market practitioners themselves rather than a system applied and administered under law. Other European countries have tended to base their regulatory system more on a statutory blueprint, setting the mould which governs the way in which financial institutions evolve. In the case of Germany, economic imperatives at the end of the Second World War, as well as the legal framework, influenced strongly their particular universal banking model. In Japan, a strong centralist tradition linked to an imported distinction between banking and securities businesses on US lines has given their system its particular characteristics.

*The Committee comprises representatives from the following countries, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

All countries, however, whatever the background to their present systems, are having to face up to the need to adapt to respond to the realities of the present global market environment. In the course of my twelve years experience with the Basle Committee it was very noticeable that country after country would talk in the Committee about the need to introduce quite far reaching legislation affecting the banking industry as a consequence of changing market circumstances. But change also grew out of perceptions of better ways of doing things as a result of discussions with colleagues in other countries, each learning from each others experiences and developing varying degrees of consensus on best regulatory practice. Despite the scale of the US economy and the range and sophistication of US financial services businesses, I believe that the United States is no more immune than others from this need to take account of the international environment for these businesses than other major industrialised countries. Indeed, it needs to take more account of the international environment than most other countries. I address this point further in the section 5 of the paper.

It therefore seems to me particularly timely for the United States Congress and the regulatory bodies to be giving close attention to the effect of the US regulatory structure on the role and the competitiveness of US financial institutions.

The following factors seem to me to be important in considering this question:-

(1) the needs of the users of financial services.

US banks, like those of many other countries, expanded abroad to meet the needs particularly of their multinational corporate customers. They followed the internationalisation of major corporations in the US, particularly since the Second World War. For the major banks, these large corporates are critical to their business and they are increasingly demanding in the range of services they look for from their bankers. With the moves to increased securitisation of banking assets and an increase in the tendency worldwide for bank financing and capital market financing to be regarded as alternatives to be used flexibly according to market terms and conditions, the constraints imposed by the Glass Steagall Act do, I believe, diminish the flexibility of the response to customer need by major US commercial banks. Of course, it is often possible, within certain constraints, for US commercial banks to set up securities subsidiaries abroad and provide a wider range of services offshore, but there must be some disadvantage in developing a multi-faceted global strategic thrust when the bank is constrained at home from doing all that it can do abroad.

(2) the experience and expertise of senior management

Structural constraints may impair the ability of banks' managements to develop the full range of skills necessary to run a global banking business and to match the skills and flexible organisation in more universal type banks abroad. This is not to say that there is not a great deal of expertise and a great innovatory impetus within many US banking institutions, but I think it is fair to say that they succeed in making their mark despite, rather than because of, the domestic regime within which they operate. Indeed, perversely, it may be said that it is the very constraints to which they are subject which have been the driving force for much of the innovation and inventiveness displayed by US banks in recent years.

(3) the diversification of risk

In a different area, recent experience has confirmed the view that, in many parts of the US banking system, the constraints on the geographical spread of business domestically has led to an unhealthy concentration of risk in different parts of the country and to undesirable consequent sectoral concentrations of risk. This has imposed strains on the US banking system generally and for many banks has weakened their domestic profitability which in all countries is a major underpinning of the ability of banks to compete effectively in international markets where competition is intense and margins tend to be thin compared with much domestic business.

(4) an excess of domestic competition

Despite the strength and depth of the US economy, the proliferation of banks, and competition from non-banks, must mean that profits are harder to earn and are spread more thinly, with the consequence either of making the banking system less intrinsically sound or of increasing the costs of banking services to the consumer. Now it is true that, over recent years, there has been a tendency toward some concentration of banking - in the "super-regionals" for example - and relaxations of the states' constraints on inter-state banking have permitted some extension of banking businesses across state lines. But the overall number of banks in the US has only declined by between 10-15% over the past decade and there still appear to be many ready and eager to start up to replace those which close, merge or fail. I feel sure however that, notwithstanding the acknowledged high levels of profitability in many well run unit banks or smaller local banks, further moves to benefit from economies of scale, leading to a better return on investment in systems and products, as well as the better diversification of risk mentioned above, should assist in the strengthening of the domestic base of US banks involved in international business. Such a trend should help indigenous US banks in competing with the many foreign banking institutions operating within the United States, many of which are less constrained in developing their business nationwide than indigenous banks because of grandfathering provisions.

(5) multiple state and federal regulators

The regulatory structure in the United States, as members of the Committee are well aware, is a source of some bewilderment to those looking in on it from the outside and it may be observed that most other countries with a federal structure (Canada, Switzerland, Germany for example) have opted for a single centralised system for banking regulation. Starting with a clean sheet, the concept of a proliferation of agencies for the regulation of banks is difficult to justify - even though, given the system as it is, no doubt much good can be derived from the high level contacts at the federal level in the Financial Institutions Examination Council. But again, if the present system works it is more likely to be despite, rather than because of, the framework that exists. In my observation, the range of different policy initiatives, often covering the same areas, pursued by the different federal agencies, the complications in policy coordination that result, and the interaction with state regulators impacts unfavourably on the cost effectiveness of the regulatory system. Outside the banking sector the absence of coordination of insurance regulation may also merit some attention and I come back to that point in the section 5 of this paper.

2 The European Community scene

The Committee is no doubt receiving much testimony about financial services businesses in the European Community and will be familiar with the programme to move toward a single market in financial services by the end of 1992. That programme is making progress. In particular, the regime for banks (or credit institutions as they are defined in the European Community legislation) is substantially in place with the Second Banking Coordination directive and the associated Solvency and Own Funds directives. These provide the basis of the home country control/"single passport" approach to doing banking business anywhere in the Community for institutions incorporated within the Community and also covers the capital adequacy regime which such institutions will be required to maintain.

For securities businesses a similar regime is proposed, involving an Investment Services directive covering institutions which carry on investment and capital market activities and its associated capital adequacy directive, adherence to which would open the door to a single passport for these businesses. In the field of insurance, the European Commission has announced that it intends to table directives of a similar umbrella character to those for banking and securities business covering life assurance and non-life insurance respectively, but progress in this area has been much slower than in banking. There are also moves to develop a community regime for investment funds.

The goal is that the whole framework should be in place by the end of 1992 to come into force at the beginning of 1993, but there must be some doubts whether this timetable will be achieved across the whole range of financial services. The Capital Adequacy directive for investment firms is very complex and needs a lot more work. It may be difficult to win agreement from all members by the end of 1992 and the Investment Services directive cannot come into effect without it. On the other hand, there are equality of competition arguments for having the regime for banks and investment businesses in place at the same time. For insurance, the road to develop a common regime for insurance has been a hard one. Insurance companies and their regulators still have a much more parochial view of their business than in the banking field and it will need a strong political commitment, as well as a lot of technical work, if the end 1992 deadline is to be met for this sector. At present the tide in Europe is running rather strongly toward achieving the goal of perfecting this framework by end 1992, but it may be that some elements of the overall package will take somewhat longer to put into place.

The regime for banks under the Second Banking Coordination Directive allows many different forms of banking business to operate under the 'credit institution' authorisation. The European Commission is at pains to point out that the terms of the Directive permit universal banking, they do not mandate universal banking. It is drawn up in a way which lists the range of permissable activities which may be undertaken by credit institutions - which are defined as institutions which "receive deposits and grant credits" - but does not require any particular range of financial services to be provided beyond those two basic functions. Thus its provisions would apply, for example, both to the existing German universal banks and to the investment banking subsidiaries of US banks incorporated within the European Community where those institutions are authorised to take deposits as part of their business.

The essence of the European Community push toward a common internal market is thus to try to encompass the various types of banking models that exist in Europe rather than seek convergence on a single model. The Commission I think would argue that, were a single market to come to pass, it should be as a result of market forces rather than an officially set framework. At present there are two main types of universal bank models in Europe: one the German version where the full range of activities are conducted within one corporate entity; the other, which may be called the English model, where a full range of financial service business is conducted through a range of companies operating in a group structure under a single holding company which may or may not be a bank.

There is no particular expectation I think at present that one or other of these two forms, or indeed any other, will come to predominate in the European Community. I would just point, however, to some regulatory considerations which may lead variants of the UK model to be preferred to the German unitary model.

As financial conglomerates or multi-faceted financial service businesses develop further and become more predominant (and there is still a widespread expectation that this will happen within the European Community in the period ahead) the problem of regulating the different activities undertaken within them becomes more complex. Regulatory jurisdictions overlap, and maybe even find themselves in conflict in the different fields of banking, securities business, insurance and investment management. It may be that, to maintain some kind of order between the different regulators' responsibilities and enable them to be carried out effectively, the argument may win favour that different functions of such businesses should be compartmentalised, with their component parts each conducted in a separate corporate entity to which, for example, different capital ratios might apply. There may be competition arguments which also point in this direction. Already some problems are coming up in the investment services area where the development of a capital adequacy regime has raised the question whether German universal banks may find themselves at a competitive disadvantage vis-a-vis separately subsidiarised investment service businesses and may feel obliged to carve subsidiaries out of their universal banks for this activity. Also, the prospect of much closer integration of insurance and banking businesses opens the question whether they should be required to be segregated in different corporate entities to provide at least a degree of protection against the risks of contagion from exposure to others risks.

It seems to me unwise, however, to expect a comprehensive or early move to uniformity in European financial service structures. The market is large and multi-variegated. It will continue to need to service a range of different customer needs. Today's fashions may be tomorrow's tragedies and continuing adaptation is likely to be necessary. There does seem though to be a strong expectation within Europe of progress toward more integration, and maybe larger cross border units, although the signs are that moves in this direction are tentative and limited in scale at present. But I believe it is likely, down the road, that US institutions both in Europe, in the rest of the world, and domestically in the United States, will be faced with strong competition from larger European-based units even if integration of business does not come about all that quickly. Recent attempts to forge major cross border links have encountered severe legal and cultural difficulties. The problem of managing large complex units, the need to move opinion among existing managers, shareholders, customers and regulators and the need to avoid upsetting confidence all argue for a longer rather than shorter time scale for these changes. But through the 1990's, if the dream of a common market in Europe becomes a reality, it seems very likely that it will be accompanied by a significant rationalisation and integration among the current range of national financial institutions. It seems unlikely, however, in such a complex and mature market, that there will not still be a place for the boutique business and for the specialist.

The impact of these changes over the coming years in Europe on the ability of US institutions to compete in Europe will depend very much on the openness with which the European Community will receive new institutions from non-EC countries and not discriminate against the large number already established. Though the freedom to operate under the single passport throughout the Community applies to institutions incorporated within the Community, the same freedoms do not currently apply to branches of non-EC entities which will remain dependent on the liberality of treatment afforded by national authorities. Clearly therefore US institutions (and those elsewhere) need to look, and indeed are looking, closely at the structure of their European businesses to minimise risks of competitive disadvantage post end-1992. I would hope, however, in the spirit of the national treatment approach (perhaps better expressed as "effective market access") enshrined in the reciprocity provisions which are to be included in the range of financial services umbrella directives for the Community, that branches of institutions from countries which can demonstrate effective financial services regulatory systems comparable in scope to Community countries will not find themselves significantly disadvantaged competitively. I do not believe that it will ever be in the interest of the European Community countries to erect unilaterally barriers for non EC businesses simply in order to keep out competition.

3 The mix of banking and commerce

I have also been asked to address the question why have banking institutions within the United Kingdom refrained from mixing banking and commerce and does this continue to make sense in the emerging global financial marketplace. This is a difficult question as the boundary between banking and commerce is not clear at the best of times and is not as far as I am aware specifically defined in UK banking law. Nor are there formal constraints in the United Kingdom on the mixing of banking and commercial business. So there is no legal prohibition on a bank owning a commercial (ie non financial) business or a major industrial or commercial corporation owning a bank. It has, however, been the policy of the Bank of England, as I recall it, to discourage sizeable and long-term investments by banks in the equity of commercial businesses as leading to undesirable concentrations of risk and as inappropriate to the fundamental intermediary and recycling function of banks and the use of depositors' funds. As to ownership of banks by non-financial businesses, such ownership may, if the banks are small, provide some comfort to regulators as a sound and substantial provider of new equity to the bank when needed. But over the years the Bank of England has tended to discourage such links, particularly because of the concern that the bank may be treated as an in-house bank by a dominant parent in unacceptable ways (eg through requiring the channelling of depositors' funds in the bank to finance the parent's business).

In the current environment the ability to maintain clear boundaries between different categories of activity in an economy is more and more difficult. Competition between banks and non-banks in the provision of certain kinds of services and the tendency of major corporations to provide much of their financing and other banking needs through their own in-house specialist department is making it very difficult to make clear distinctions, and indeed to decide, for regulatory purposes, which entities and which activities need to be regulated and which not. This problem of the boundary between financial and non-financial businesses is one with which many countries are wrestling currently. It may be that some greater direct involvement of banks in commercial enterprises other than through lending or short term market operations may be justified in a competitive market but, if permitted, it is important, in my view, that it should be accompanied by effective safeguards and careful supervision on the part of the regulators. Also the perceived benefits of such associations, at least in the view of some German and Japanese bankers where these links are significant (if historic), may be more apparent than real. Similar benefits may be achievable without the formal ties, and these ties may in practice be counterproductive, restricting flexibility and independence in the market.

The difficulties in establishing clear boundaries for financial activities and limits to the scope of financial service businesses is also posing difficult conceptual "framework" problems for many countries as to whether financial regulation should be organised on a functional or institutional basis. The resolution of this problem becomes even more difficult when looking at financial businesses on an international basis.

4 Deposit insurance

Most countries in Europe have some form of deposit protection scheme. An EC instrument of 1986 "recommends" that all EC members should have one. In the course of the discussions among the national authorities in the European Community and the European Commission before the policy set out in the Second Banking Coordination Directive was agreed, there was some debate whether, in addition to a common minimum capital standard, a system of depositor protection ought to be a prerequisite before granting the single passport to EC banks. It was eventually decided that such a measure, which conceptually would have needed to be broadly comparable in scope but not identical from country to country, was not an essential feature of the new approach. But nevertheless ten of the twelve EC countries now have schemes in place and in the other two (Portugal and Greece) they are in contemplation. Further efforts to produce a greater consistency of approach within the Community may well be attempted in the next few years.

There is little consistency in the detail of the schemes in different countries. Their coverage varies but normally covers all deposit taking institutions. In some countries there are different schemes for different categories of institutions which accept deposits. Some of the schemes - for example, in the United Kingdom, France, the Netherlands and Ireland - are compulsory; others - in Belgium, Germany, Italy and Spain, for example - are in principle voluntary although all banks or members of the association of banks administering the schemes are generally enrolled. In some countries, including Belgium, the Netherlands and the United Kingdom, branches and subsidiaries of foreign banks are required to participate in the scheme; in Germany they are entitled to do so. The currency coverage also varies. In Germany, the Netherlands and Spain, for example, deposits are protected irrespective of currency, while in Belgium, France and the United Kingdom, foreign currency deposits are expressly excluded. Almost all the schemes limit themselves to non-bank deposits. The Netherlands scheme restricts protection generally to small personal depositors. The UK scheme excludes deposits with a maturity of over five years and certain connected and secured deposits. The Belgian scheme excludes deposits held on 'abnormal' conditions, those held by fraudsters and deposits already covered by foreign deposit protection arrangements.

As to the scale of protection, the German commercial bank scheme (there are separate schemes for other groups of deposit taking institutions) comes closest to providing comprehensive protection with a maximum per client defined as 30% of the liable funds of an individual bank. Others normally have a maximum size of deposit which qualifies for protection, most of them substantially lower than the local currency equivalent of the US limit of $100,000. In Ireland, Italy and the United Kingdom, depositors receive compensation at less than 100% of the deposits covered. In the United Kingdom, and elsewhere, it was felt that the principle of "caveat emptor" should not be ignored and depositors should accept some responsibility for their decisions where they place deposits.

The administration of the schemes also varies considerably. Most are officially run, but some are run by the industry. In the Netherlands it is undertaken within the Central Bank with advice from banking participants; in the United Kingdom there is a separately constituted Deposit Protection Board with some commercial bank members, but the majority of its members are from the Bank of England. The Italian, Swiss and German schemes are administered by the banking associations. They are all more recent than the US scheme; most of them have been introduced in the 1980's, one or two a decade and more earlier.

The resources for the schemes in Belgium, Germany, Italy and Switzerland are provided by regular subscriptions and these can be varied according to need. In most countries, finance is provided by the participating banks on a scale based on total insured deposits as and when required, although there is also a small paid up fund in the UK and some countries require a minimum contribution from all institutions. Some countries can obtain further finance from the Central Bank or through borrowing, but in Germany, Italy and Switzerland, where the scheme is based on the philosophy of self-help within their banking system without public sector support, funds are not provided from outside the participating institutions.

The systems are thus very varied but generally may be described as designed to provide significant protection for the small depositor in the event of a bank failure. They are not conceived of as providing a general underpinning of the banking system as a whole although of course they do play a part in underpinning public confidence. In all countries, it may well happen that all depositors of a problem institution are in practice fully protected because the authorities arrange a merger or a takeover or occasionally acquire an institution themselves and work it out.

Normally, in the context of universal banks of the German model, in the event of a failure of a banking institution, the question of whether the losses precipitating the failure arose from banking, securities or insurance activities would not be a concern as the authorities would have already accepted that these activities were appropriate uses of depositors monies. In the case of banking groups where a deposit taking institution is a separate legal entity from its affiliated securities or insurance business, the deposit-taker might be brought down by some contagion with problems in the failed securities or insurance business but it would be more likely to be an 'indirect' consequence of the affiliate's failure (ie a general loss of confidence in the group) rather than a direct consequence of the deposit-taker being drained of resources in trying to bolster up the securities or insurance affiliate. I do not know, however, of any specific provisions in European deposit protection schemes which bar such intra-group movements in order effectively to preclude the resources of the deposit protection fund being paid out as a consequence of losses in securities, insurance or other non-banking activities.

The deposit protection schemes in Europe do not differentiate between large and small institutions and there is no different treatment or approach for those institutions which the authorities may consider to be 'too big to fail' and for those which are not. In saying this I do not wish to imply that European authorities necessarily have 'too big to fail' precepts or policies.

5 Future trends and developments in the global financial services industry

The main factor affecting the future evolution of international financial services businesses is the all pervasive influence of the globalisation process in financial markets. It is a commonplace that there is now an increasingly integrated market for financial products of a global dimension. With the effective removal of exchange control restrictions in all major countries, completed by the adoption of the liberalisation of capital movements directive of the European Community effective this year, individuals and businesses can, and increasingly do, shop around internationally for products and services. The regulation of the global market by different national regimes is being slowly but increasingly coordinated. It will, in my view, be of crucial importance for the future smooth running of the international financial system, and the banking system in particular, that the framework within which it operates at the national or, in the case of the European Community, the regional level should be as cohesive and compatible from centre to centre as possible. We are not likely to achieve nor should we probably set out to achieve uniformity, even within Europe, but as far as possible the national system should be set in broadly similar moulds in the main centres.

This, I hope and trust, is one of the considerations in the minds of those in the United States and Japan who are looking closely at their domestic structures at the moment. In some material respects both countries are out of step with the way structures are developing in most other countries. Now it may be debated whose systems are the ones which are out of step, but I believe the tide internationally is flowing strongly toward a European rather than the US or Japanese models. As discussed earlier, this difference in framework accounts for at least some of the competitive problems with which the US banking system sees itself faced. For the Japanese commercial banks, they clearly wish to see the Article 65 constraints on engaging in securities business removed. But I suspect, more generally, they do not see themselves to be as disadvantaged by their structure as the US banks because their framework has permitted a much greater degree of concentration of their banking system domestically and because they do not have the same multiplicity of regulatory agencies - even if they have their own kind of regulatory 'creative tension' within the Ministry of Finance.

So it seems to me very important for the effective management of the international financial system that the authorities, most particularly in the three major marketplaces - the European Community, the United States and Japan should strive to develop, in broad terms, compatible, and maybe in many respects similar, frameworks for the organisation and regulation of financial services businesses.

The Banking Supervisors have made some useful progress in this direction. The Capital Adequacy accord of the G10 major industrialised countries in Basle and the European Community directives on bank capital are in most important respects similar. A few years ago the level of bank capital was very uneven as between major countries, the method of assessing its strength not at all the same and the definitions of capital itself very different. We now have the prospect at the end of 1992 of a single uniform approach which should materially assist the levelling of the playing field and the equalising of one important aspect of competition - although of course there are many others.

Maybe, if we are fortunate, a similar regime can be put in place for securities businesses. Here, Europe is currently ahead of the field and it will be important that the US and Japan keep close to the developments there. I believe that the argument for compatibility points to the desirability, in the interests of their own banking systems as well as for the more general good, of making some change in their frameworks. It is important that, in looking at their domestic systems, they do not ignore the global environment within which their institutions operate. Equally, in this particular area, it will be very important that Europe should not rush ahead too quickly to set in concrete a system to which other major marketplaces cannot then easily relate.

Looking further ahead, we are also seeing, for good or ill, a trend to much closer integration of banking and insurance business - both in terms of merging of businesses or participations and in the common marketing of products. This movement is somewhat contrary to the historic view of many regulators of both these industries in many countries that close links are undesirable and can be dangerous. These risks may have become less because regulators are more effective (a questionable thesis) or the pressure to relax from the market may now be overwhelming (the more likely undercurrent), but whatever the reason it seems to me it will be important to ensure that national insurance regulators, just as in the past banking regulators, and currently securities market regulators, are fully alive of the international dimension of these growing links. Indeed I believe it would be useful if efforts could be made to bring national insurance regulators closer together with their colleagues in different countries, as well as with the banking and securities market authorities, to anticipate problems that may be looming ahead rather than waiting for a disaster to spur action, as unfortunately all too often occurs. To achieve these closer links is not easy, because the regulation of the insurance industry is very nationally orientated and in a number of countries it is not handled at the central government level, but I believe such a move would be timely. Regulators may not wish to stultify innovation and the natural evolution of markets, but they must also not lag too far behind developments in the market.

Conclusion

I have sought in this limited paper to cover the main issues which you have asked me to address. In the world of today, in financial business even less than in other areas of economic activity, no financial activity can be an island. National self interest as well as overall benefits call for continued strong cooperative efforts to promote a sound and cohesive international financial system responsive to the world's needs. Uniformity may not be realistic and not even desirable as diversity adds great value to markets. Each country needs to reflect in its institutions and organisations it particular history, culture, and established ways of doing things. But, if I may presume to say so, it is because the United States is the strongest economy in the world that there is a dimension to your deliberations on your national financial framework which is of the utmost significance to the rest of the world. There is an interest and a concern in all countries that any changes here, as well as serving the interests of the United States, should at the same time assist the US economy and its financial institutions to play their full part in world markets for the wider good.

The **Chairman**. Thank you, Mr. Cooke, for a very thoughtful statement.

I want to say before going to our next witness that Senator D'Amato was here, but had to be on the floor managing part of the bill that is on the floor at the present time. He expresses his regrets and has left a statement to be put into the record, and I would ask unanimous consent that we make it part of the record at this time. I also have a statement for the record from Senator Dixon.

STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, the time has come for a broader debate, one focused upon foreign competitiveness. More specifically, the time has come for an alternative legal and regulatory structure that permits the free market rather than governmental inertia to determine whether any type of business is comparable with ownership of a depository institution. It is time for the efficient, rationally integrated American financial services companies to compete in the global financial services industry.

Mr. Chairman, we must permit diversification of strong financial services companies and open up new sources of capital for the banking industries; strengthen and rationalize regulation; insulate depository institutions from the risks of their subsidiaries; promote the interest of consumers through promoting cross-marketing of financial services; and enhance public confidence in the financial services industry.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. President, I am pleased to be here this morning as the Senate continues its hearing on financial services developments in Europe and Japan, and their relevance to financial services law reform here in the United States. We have a good group of witnesses before us today, and I look forward to their testimony.

There is much we can learn from foreign experience. It is worth remembering. However, that in some areas, both Europe and Japan are only now beginning to feel the stresses and changes that have been at work for years here in the United States.

I have been a strong supporter of reform. I think it is important to note that reform and deregulation are not the same thing. Those of us interested in giving bank holding companies the right to own and operate securities affiliates, for example, are not proposing less regulation. What we are proposing is to allow well-capitalized bank holding companies to conduct these activities outside of their banks—that is, outside the deposit insurance system—subject to all appropriate regulation and supervision.

A banking deregulation bill would not pass the Senate. No such legislation should pass the Senate. But the reform legislation I am the author of in this Congress passed the Senate in 1988 by the overwhelming vote of 94 to 2 because the Senate knew that the bill was not deregulation, that it was the kind of reform that made sense and was long overdue even then, and that we had the right kind of regulation and supervision to ensure that the safety and soundness of our banking system would be protected.

The concerns that motivated the Senate to act in 1988 are even more compelling now. We do not need to act on a package of sound, sensible reforms.

I am developing a package of deposit insurance reform proposals that are essential in their own right. However, I believe banking law reform needs to go hand with deposit insurance reform. These two steps, taken together, will ensure that our banking system is able, prudently and successfully, to play its role in our economy—to be an asset that enhances American international competitiveness, instead of a liability that impedes our future ability to compete in world markets.

The **CHAIRMAN**. Senator Pressler, did you have an opening comment that you would like to make?

Senator **PRESSLER**. I have no opening comment. I may be called to the floor to protect the rights of small States, but if nothing happens to small States, I'll be here.

The **CHAIRMAN**. Very good.

The **CHAIRMAN**. Mr. Chisholm, we are very pleased to have you, and we would like to hear from you at this time.

STATEMENT OF JEFFREY S. CHISHOLM, VICE CHAIRMAN, OF THE BANK OF MONTREAL, TORONTO, CANADA

Mr. **CHISHOLM**. Thank you, Mr. Chairman.

Senators, good morning. Thank you for providing me the opportunity to discuss the issue of global financial services trends and developments. My focus will be primarily on the United States/Canada experience. In some respects I think I may be uniquely placed to discuss Canada/United States cross-border issues in banking having spent 13 years with the Harris Bank in Chicago in various capacities and the last 6 years at the Bank of Montreal in Toronto. I think this has allowed me to see the strengths and weaknesses of both systems.

Before I begin, I thought I might briefly acquaint you with the Bank of Montreal. With assets of more than $67 billion, the Bank of Montreal is among the 10 largest banks in North America. It has always had very strong ties with the United States. Its first representative in New York was appointed in 1818, which is just 1 year after the founding of Canada's first bank.

It has had a long association with Chicago, which was of course considerably expanded by the purchase of the Harris Bank Corp. in 1984.

Beside Harris, our other major subsidiary is Nesbitt Thomson, Inc., which is one of Canada's largest investment dealers. We purchased a 75 percent share in Nesbitt in 1987 when new legislation went into effect in Canada permitting banks to enter into the securities business. Our experience in combining banking and securities might be of interest to you, and I would be pleased to respond to any questions you might have in this regard.

But, first, let me turn to the regulatory and supervisory structures in Canada and the United States and the impact that each has on the relative competitiveness of their financial institutions.

There are several differences between Canada's regulatory system and your own.

The first difference regards the whole approach of the regulator in Canada where there is more reliance on corporate self-regulation. The supervisor's role is more of auditing the auditors than acting as auditor per se.

The second difference regards the tone of the relationship. Generally banks have a good relationship with the Superintendent of Financial Institutions, one characterized by open communications, pragmatic problem solving and consultation. In short, no surprises at all.

By contrast, we have found the U.S. regulatory system to be more adversarial and unnecessarily cumbersome. For example, approval to purchase the Harris Bank took more than 9 months and required the submission of several thousand pages of documentation.

Another subsidiary of ours, Harris Government Securities, must undergo up to six independent regulatory audits each year in addition to the audits for our shareholders and our own internal purposes. Put another way, there are only 3 months of the year that a regulatory audit is not underway in any 12-month period.

Procedures as this, both at the Federal and at the State level are inefficient, they are time-consuming and costly while doing little or nothing to reinforce the underlying principles of good regulation.

Let me now turn to the issue of deposit insurance. No one questions the need to devise a fair and efficient system to deal with the effects of troubled or failed financial institutions, but I would rather focus my remarks this morning on the more important issue: how to reduce the risks of such failures in the first place.

One possible step is to raise the start-up requirements. Make it tougher for new players to enter the business and require that they meet fit and proper tests.

However, if there is no other message I can leave with you today, it is the need for the U.S. banking system to foster a stable deposit base. It is our view that the removal of all barriers to interstate banking, which is directly related to the formation of a stable deposit base, would both enhance profit opportunities significantly as well as improve the safety and the soundness of the system.

Canadian banks, for instance, offer banking services nationally and have therefore developed large sophisticated branching networks that stretch from coast to coast. These extensive retail networks provide them with a very stable deposit base which accords the system therefore much greater stability and safety than would otherwise be the case.

One need only look at the facts to see what this can mean. During the Depression of the 1930's when 9,000 U.S. commercial banks failed, there was not one banking failure in Canada, nor even a temporary suspension of banking services. In the decade of the 1980's, which witnessed several hundred more U.S. bank failures, the Canadian experience again was much better.

Similarly, in instances where banks here have had extensive retail deposit networks, they have been able to weather difficult times much more effectively than banks that relied extensively, if not almost exclusively, on the wholesale deposit market.

Another problem with a geographically restricted banking system is that it promotes heavy reliance on regional lending, and when you combine that with a very fluid deposit base, you inevitably have problems.

Now I would like to turn to the issue of mixing banking with commerce. There has been considerable debate over the past decade in Canada about the ownership of financial institutions and the commingling of financial and commercial enterprises. Concerns were heightened by the failure during the 1980's of more than a dozen non-bank financial institutions, most of which were closely held and linked to commercial enterprises. We are still awaiting the Canadian Government's plan to deal with this.

In our view, maintaining the independence between financial and commercial sectors is of fundamental importance. Deposit taking institutions are entrusted with depositors' money. This is akin to a fiduciary responsibility and strict precautions are required to avoid the hazard of depositors' money finding its way into excessively risky industrial and commercial purposes through highly complex and obscure intra-company transactions.

I have another fundamental concern with mixing commerce and banking. I question whether consumers will be well served by a company whose primary business is not banking and for which financial services is a sideline. One can imagine, for instance, the financial services offering of such a company might become a loss leader to boost sales of the company's primary product to the detriment of the industry overall I would argue.

Finally, let me say a few words about some trends in global financial services and comment on our ability to compete.

Canada's banking environment has become increasingly liberalized during the past decade. Yet, despite the reduction in barriers, it is not entirely clear that the banking system in Canada is any more competitive than before. One concludes that Canada's banking system was already highly competitive, not because of the actions of regulators, but because of the marketplace itself.

My point is simply this. Regulators often find that rules cannot be written fast enough to keep up with the changes in the marketplace. Once the regulatory barriers are brought down or reformed, it is largely anticlimactic. There aren't many unexploited profit opportunities left.

So when and if Glass-Steagall is gone, we may well discover that the market has been far ahead of the regulators and that the effects may be minimal. This is not to say that Glass-Steagall should not be repealed. It should. Just as we feel that the stability of the U.S. banking system would be enhanced by broadening the deposit base, so, too, will it be strengthened by permitting banks to diversify their assets. Indeed, these powers are essential if the U.S. banks are to remain competitive, particularly as new capital adequacy standards influence their allocation of resources.

This is all the more crucial because both Canadian and United States money center banks already find themselves at a competitive disadvantage internationally. Our banks face a higher effective cost of capital which is largely the result of risk premiums demanded by the market.

To conclude, we believe the U.S. financial services industry is overly restricted and overly regulated. Given that North American banks are already at a disadvantage because they face a higher effective cost of capital, you should remove other structural barriers that reduce their ability to compete.

We believe you should take steps soon to eliminate the barriers that prevent commercial banks from underwriting securities and, more importantly, the barriers that prevent them from engaging in interstate banking. We believe you should reduce the regulatory burden and replace the adversarial approach to regulation with one of cooperation, and we believe your goal with regard to deposit insurance should be to create a system that reinforces the disciplines of the marketplace. No institution is too big to fail.

And, finally, we believe that maintaining independence between the financial and commercial sectors is of fundamental importance and is in the best interest of all depositors.

Thank you very much for the time.

[The complete prepared statement of Jeffrey S. Chisholm follows:]

SUBMISSION BY

JEFFREY S. CHISHOLM

VICE-CHAIRMAN

BANK OF MONTREAL

TO

THE U.S. SENATE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON

JUNE 20, 1990

The Canadian Financial Services Industry

The Canadian financial services industry was built upon the so-called Four Pillars -- banking, trust, insurance and securities -- and, until recently, cross-over between the pillars was highly restricted. In Canada, as elsewhere in the world, the pillars began to crumble in the mid-1980s.

Canadian banks, like their U.S. counterparts, are empowered to offer a wide range of deposit and lending services to individuals, small- and medium-sized businesses and corporations. Unlike U.S. banks, Canadian banks do not have fiduciary powers.

Canadian domestic banks have ownership restrictions: No one shareholder can own more than 10% of a bank's shares, unlike the U.S., where closely held banks are common.

Canadian banks are few in number, and there is relatively more homogeneity among them: Of the eight domestic banks in Canada, all of them, from the smallest to the largest, tend to offer the full range of services; U.S. banks, by contrast, number in the thousands and range from the smallest, single-unit, family banks -- offering strictly retail banking -- to super-regionals, catering to retail and commercial needs, to the Money Centre banks which count themselves among the world's largest.

The geographic scope of Canadian banks is the one respect in which the Canadian banking system differs most significantly from the U.S. banking system. Canadian banks offer banking services *nationally* and have, therefore, developed large, sophisticated branching networks stretching from coast to coast. In the case of Bank of Montreal, Canada's 4th largest, it has a network of nearly 1,200 branches serving 4 million customers in Canada's 10 provinces and 2 territories which poses an enormous technological challenge. Of the U.S. banks, the only ones with comparable experience are the largest California banks, which also offer a full range of services through large networks of branches. In our view, the national scope of Canadian banks is a source of major strength and stability for the Canadian banking system.

Until 1987, Canadian banks had one other feature in common with U.S. banks -- the restriction on entering the securities business. In 1987, however, the Canadian government enacted legislation permitting banks to establish or acquire investment dealer subsidiaries. Bank of Montreal was the first to avail itself of this opportunity, with the purchase of Nesbitt Thomson, Inc., Canada's 4th largest investment dealer. Canada's other major banks were quick to follow, and one bank established its securities operation *de novo*.

While the business environment for investment dealers understandably soured in October, 1987, on balance, Bank of Montreal is quite satisfied with its purchase of Nesbitt Thomson. More to the point, the Bank has experienced none of the problems feared by opponents of re-regulation. The prudential standards for investment dealers that were in place pre-1987 remain in place. Nesbitt continues to operate as a separate entity, with its own regulator, its own conflict of interest guidelines, its own "Chinese walls" -- and its own culture -- and, within those guidelines, is benefitting from the synergies of having a bank parent. The Bank benefits by being able to meet its customers' increasingly sophisticated financial needs, thereby not losing the business to a competitor.

Regulatory Environment

The central imperative of good regulation is protecting the overall integrity of the system, its safety as a repository for depositors' funds and its stability as a source of credit for personal and commercial borrowers. However, regulatory regimes which overlap and compete, operating in a confrontational manner with each other and with those they regulate, can be a de-stabilizing force, draining physical and financial resources and impeding the efficient functioning of the marketplace.

In comparison with the U.S., the Canadian regulatory system is relatively straightforward and characterized by generally harmonious relationships, both between regulatory regimes, and between regulators and regulated.

Banks in Canada are regulated exclusively by the federal government through the Office of the Superintendent of Financial Institutions (OSFI). Trust companies and insurance companies may choose to be chartered either federally or provincially and, if they choose a federal charter, they too are regulated by OSFI -- otherwise, they are regulated by the province, which also regulates credit unions (cooperatives specializing in consumer and mortgage loans). The responsibility for regulating securities activities also rests with the province.

When, in 1987, banks were permitted to enter the securities business, the law specified that the bulk of a bank's securities operation must be held in a subsidiary which, in turn, would be provincially regulated. In fact, this is generally the way regulators in Canada get around the question of whether to regulate by function, or by entity: Where there are functions that should be regulated separately, they are generally isolated in separate subsidiaries. In this way, while banking activities are generally supervised at the federal level, some of their subsidiary activities are supervised provincially.

In the past, this was limited to minor activities, relatively speaking, such as the operations of some mortgage corporations. With re-regulation, however, the scope of provincial regulation of banks has widened as banks have acquired securities dealers and set up mutual funds. Moreover, legislative proposals currently pending will generally permit banks, trust companies and insurance companies to compete in each other's core markets (subject to certain notable exceptions, such as insurance distribution and car leasing, which will continue to be prohibited to banks). To the extent that these proposals confer further powers on banks, provincial regulators may continue to expand their influence on the banks' operations.

The degree to which these developments add complexity to the Canadian regulatory environment will depend, in part, upon the success of efforts by the provinces to harmonize their rules and procedures. Over the past few years, the provinces have demonstrated more of a commitment to harmonization than at any other time in the past, and we view this as an encouraging sign, even though there remains much work to be done in this regard.

So far, we have found that the relationship among regulators in Canada -- primarily the federal government, and the larger provinces of Ontario, Quebec and British Columbia -- is on the whole marked by a willingness to consult and cooperate, notwithstanding some tensions at the political level prompted by evolving roles under re-regulation. By way of example of this positive climate, banks are permitted to conduct certain securities activities in-house, i.e., they need not be isolated in the securities subsidiary. These include trading for their own account and underwriting commercial paper. Through negotiation, federal and provincial regulators were able to agree that these activities would be supervised federally.

Similarly, the relationship between banks and the Superintendent of Financial Institutions is marked by a spirit of consultation and cooperation -- perhaps even more so than between levels of regulators.

There are several differences between the relationship of regulat*ed* to regulat*or* in Canada *versus* the United States. The first difference regards the whole **approach** of the regulator in Canada *vs* the U.S. In Canada, there is more reliance on corporate self-regulation. The supervisor's role is more that of auditing the auditors, than that of auditor *per se*. In part, that is because a Canadian bank, unlike any other company in Canada, is required to have two sets of independent auditors and, by law, the auditors are regularly changed.

The second difference regards the **tone** of the relationship. Generally, the banks have a very harmonious relationship with the Superintendent of Financial Institutions, one characterized by open communications, pragmatic problem-solving, consultation -- in short, "no surprises." This may be, in part, because there are only six major banks in Canada; by the same token, there are relatively few money-centre banks in the U.S., yet it appears they do not enjoy a comparable relationship with their regulator.

In Bank of Montreal's experience, the U.S. regulatory system is more adversarial and unnecessarily cumbersome. Approval to purchase the Harris Bank, for instance, took more than nine months and required submission of thousands of pages of documents. More telling, perhaps, is the Bank's experience on each of the eight subsequent occasions that Harris Bank has made a suburban bank acquisition. In each case, regulators have required not only that Harris file extensive information, but also that Bankmont Financial (the Bank's U.S. holding company) and even the Canadian parent, Bank of Montreal, file detailed information regarding asset quality, consolidated bank capital plans, comparisons of performance to major Canadian and U.S. banks and the rationale for viewing the parent bank holding company as a source of strength. Generating this material takes many weeks and is required even though no material changes have occurred since the previous filing, which may have been only six months earlier.

This explains, in part, the Bank's reluctance to be listed on U.S. stock exchanges. It does not wish to be subjected to a wide range of new reporting requirements, which are not required by Canadian authorities.

Another example of excessive paperwork relates to the Bank's subsidiary, Harris Government Securities. Although it is a relatively small operation, with $25 million in equity, it must undergo up to six independent audits each year -- by state and federal regulatory authorities, by the Securities Exchange Commission, the National Association of Securities Dealers, the Chicago Federal Reserve Board, the New York Federal Reserve Board's Dealer Surveillance Unit, the Securities Department of the State of Illinois Office of the Secretary of State and the state bank examiners -- in addition to audits for shareholders and Bank of Montreal's own internal purposes. Depending on the scope of any particular audit, the subsidiary is subjected to surveillance for up to eight months in any given year.

Procedures such as this, at both the federal and state level, are inefficient, time consuming and costly, while doing little or nothing to reinforce the underlying principles of good regulation. In our view, good regulation need not be adversarial.

We also believe that the U.S. regulatory regime must become more flexible in dealing with foreign-owned banking operations. The regulations should permit regulators to recognize the strength of a foreign parent, rather than being unable to see beyond the U.S.-incorporated bank holding company.

Deposit Insurance

The deposit insurance systems in the U.S. and Canada are very similar. Membership in the Canada Deposit Insurance Corporation (CDIC) is compulsory for chartered banks and federally incorporated loan and trust companies, and is voluntary for provincially incorporated trust and loan companies -- although, in practice, virtually all such companies are members. Credit unions are insured through a variety of provincial stabilization funds, which are typically member-funded, back-stopped by provincial treasuries and without coverage limits.

Depositors in member institutions of the CDIC are separately insured for each eligible category of deposit, including savings and chequing accounts, term deposits, deposits held in trust and retirement plans invested in qualifying deposits. The insurance does not cover foreign currency deposits, deposits made outside of Canada or deposits with an original term to maturity greater than five years. Canada has a somewhat lower limit than the U.S. -- C$60,000 compared with US$100,000 -- but the principle of coverage is essentially the same: to protect small depositors. Large depositors are assumed to be more sophisticated investors and not require protection.

No one questions the need to devise a fair and efficient system to deal with the effects of troubled or failed financial institutions, but the more important issue is how to reduce the risk of such failures in the first place. One possible step is to raise the start-up requirements -- make it tougher for new players to enter the business, and require that they meet "fit and proper" tests. However, the one change that is the most critical to the safety and soundness of the U.S. banking system is the need to foster a stable deposit base.

It is our view that the removal of all barriers to interstate banking, which is directly related to the formation of a stable deposit base, would both enhance profit opportunities significantly as well as improve the safety and soundness of the system. And because of the critical role of the U.S. financial system in the global financial network, such a move would also strengthen the safety and soundness of the global financial system.

As an historical aside, the Canadian and U.S. banking systems share a common heritage; both were based on the Charter of the First Bank of the United States, drafted by Alexander Hamilton. This Charter established a nationwide system of branch banking which still exists in Canada. The U.S., on the other hand, abandoned nationwide branch banking in 1836, under well-known political pressures. Whatever the merit of those political pressures then, the experience of Canada's banking system -- whose safety and soundness is unquestioned -- argues eloquently for the U.S. to abandon quickly all remaining interstate restrictions. The fragmentation of the U.S. banking structure not only places U.S. banks in a weaker position as they compete for market share nationally and internationally, but it also denies them access to stabilizing elements necessary to absorb shocks during periods of uncertainty or economic downturns.

As noted earlier, the Canadian banking system is characterized by a few large banks with nationwide branch networks. Together, they serve more than 1,700 communities through 7,300 branches. Six banks control about half of all personal deposits, nearly two-thirds of personal loans and one-third of all mortgages outstanding. They hold 30 million personal savings accounts -- a number greater than the country's population. The Canadian market is also served by 58 smaller banks -- 56 of them foreign-owned -- as well as 80 trust companies and some 3,000 credit union branches. These non-bank institutions have been growing more rapidly than the banks in recent years, to the point that some now rival the banks in size.

The banks' extensive retail networks provide them with a very stable deposit base, which allows them much greater flexibility in terms of their banking operations and which accords the system much greater stability and safety than would otherwise be the case. The failure rate of Canadian institutions is much lower than in the U.S. During the depression of the 1930s, when 9,000 U.S. commercial banks failed, there were no banking failures in Canada, nor even a temporary suspension of banking services. In the decade of the '80s, which witnessed several hundred more U.S. bank failures, the Canadian experience again was much better. The structure of the Canadian banking system -- with coast-to-coast branches and a stable deposit base -- was the major contributing factor.

The experience here in the U.S. leads to the same conclusion. In instances where banks have had extensive retail deposit networks, which are the foundation of a stable deposit base, those banks have been able to weather difficult times much more effectively than banks that relied extensively, if not almost exclusively, on the wholesale market. Wholesale deposits, by their nature, are not a stable funding base. Nervousness about the health of an institution can trigger substantial outflows in a matter of days or even hours.

Another problem with a geographically restricted banking system is that it promotes heavy reliance on regional lending, sometimes prescribed by government. For instance, legislation that requires the allocation of loans to certain segments of the community -- as is the case, for example, with the Community Reinvestment Act -- may exacerbate the situation of a bank which already has a narrow lending and funding base. While the underlying intentions of such programs are socially and morally laudable, the goals could be more readily and safely attained if a broad, stable deposit base were already in place.

Whether prescribed by government or not, a reliance on regional lending, combined with a very fluid deposit base, inevitably spells problems. One need look no further than New England, Texas and Oklahoma for evidence of the adverse consequences that may result. Opportunities to spread risk through loan and product diversification in the U.S. are more limited than in a system such as exists in Canada and several other countries of the world. It is noteworthy that in the case of two Canadian bank failures (the Canadian Commercial Bank and Northland Bank in 1985 -- the only such failures since 1923), both institutions were heavily dependent upon regional lending and wholesale funding.

Between them, the two failed institutions held less than 2% of all deposits. In Canada, the notion of "too big to fail" has never been tested -- except by the industry; the industry has always closed ranks to prevent a major failure, either by merger or acquisition of the troubled institution. Canadian banks are extremely committed to the integrity of their system, because it relates directly to the issue of confidence.

In both cases of bank failure just mentioned, deposit insurance came to the rescue of depositors. Indeed, it was *more* than generous, repaying not only insured depositors, but all *un*secured depositors as well -- all, that is, except banks, which contributed directly to the rescue attempts and have been contributing *in*directly ever since through higher deposit insurance premiums. Furthermore, in Canada, as here, these premiums are calculated as a flat percentage of the deposits held by member institutions.

On the one hand, then, while less prudently managed institutions prompt the vast majority of claims, the six banks which are predominant in the market bear by far the greatest share of the cost, quite out of proportion to their depositors' risk. On the other hand, government decisions to pay depositors beyond the insured limits and to compensate unsecured depositors remove the discipline of the marketplace, and provide little incentive to avoid excessively risky behaviour. This is not only unfair to the prudently managed institutions which must bear the cost, but can also promote instability in the financial system over the longer term. The system's fundamental flaw is that it subsidizes those deposit-taking institutions that take excessive risks with the money entrusted to them and, in some cases, it covers not only risk, but also incompetence and dishonesty.

To deal with these concerns, the Canadian banking industry has advocated a move toward some form of deposit co-insurance, claims-based insurance premiums (in preference to the existing flat rate system) and separate insurance pools for banks and non-banks.

Mixing Banking and Commerce

There has been considerable debate over the past decade in Canada about the ownership of financial institutions and the co-mingling of financial and commercial enterprises. Concerns were heightened by the failure during the 1980s of more than a dozen non-bank financial institutions, most of which were closely-held and linked to commercial enterprises.

The large Canadian banks are widely-held, with no single investor permitted to own more than 10% of the voting shares. Chartered banks are also restricted from owning greater than 10% of the voting shares of any commercial firm. All the major trust companies, on the other hand, are narrowly-held and most also have a commercial company as their majority shareholder.

The federal government's proposals for re-regulation of the financial sector, announced in 1986, included measures to halt the growth of commercial/financial links and, where they exist, to roll them back over time. However, we are still awaiting the introduction of legislation and the government's commitment to that approach remains uncertain.

Maintaining independence between the financial and commercial sectors is of fundamental importance. Deposit-taking institutions are entrusted with depositors' money. This is akin to a fiduciary responsibility and strict precautions are required to avoid the hazard of depositors' money finding its way into excessively risky industrial and commercial purposes through highly complex and obscure intra-company transactions. In trying to control such risks, regulators are likely to find themselves out-distanced and out-foxed under the pressure of strong market incentives, particularly during periods of financial stress. A clear separation of the financial and commercial sectors provides stronger protection against self-dealing and conflicts of interest and a firmer foundation for the stability and safety of the system. This should be achieved both through ownership restrictions which prevent the formation of upstream commercial links, and legislative prohibitions against downstream links. In addition, ownership restrictions will help to preserve domestic control over a country's major financial institutions, as markets internationalize and trade liberalization gains momentum.

Competitive Environment

Canada's banking environment has become increasingly liberalized during the past decade. For instance, the Canada-U.S. Free Trade Agreement, which took effect January 1, 1989, essentially removed any remaining barriers for American banks, putting them on an equal footing with Canadian banks. Indeed, one U.S. institution, American Express, was granted approval in April to establish a bank in Canada, even though it is not regulated as a bank in the U.S. It seems it will be allowed to carry out activities in Canada which are not even permitted for Canadian banks. Also under the Free Trade Agreement, Canadian banks will eventually benefit with U.S. banks from whatever liberalization of banking laws takes place here.

Yet despite the reduction in barriers to foreign bank activities in Canada in the past several years, it is not entirely clear that the banking system in Canada has been made significantly more competitive than earlier. Consider the financial results of the foreign banks operating in Canada today. With few notable exceptions, the financial results have been poor, even in a more liberalized regulatory environment, suggesting that there did not exist huge unexploited profit opportunities in the Canadian market. One concludes that Canada's banking system was already highly competitive -- not because of the actions of the regulators but because of the marketplace itself.

The increasing globalization of financial markets, driven arguably by an explosion in high speed communications and information technology, meant that Canadian banks faced increased direct competition from foreign banks. Moreover, those banks did not have to be on Canadian soil to compete with Canada's banks. Increasingly, borrowers and investors could access financial markets directly in their own names, forcing all financial institutions around the world to become more competitive.

The point is, regulators often find that rules cannot be written fast enough to keep up with changes in the marketplace. Once the regulatory barriers are brought down or reformed, it is largely anticlimactic; there aren't many unexploited profit opportunities left. So, when and if Glass-Steagall is gone, we may well discover that the market has been far ahead of the regulators and the effects may be minimal.

In Canada, we certainly witnessed no dramatic changes when banks were permitted to acquire or establish securities operations. Profitability in the securities industry is unchanged -- except insofar as market conditions dictate -- and the change in ownership has been transparent to customers.

This is not to say that Glass-Steagall should *not* be repealed. It should. Just as we feel that the stability of the U.S. banking system would be enhanced by broadening the deposit base, so too will it be strengthened by permitting banks to diversify their assets. Indeed, these powers are essential if U.S. banks are to remain competitive, particularly as new capital adequacy standards influence their allocation of resources.

This is all the more crucial because both Canadian and U.S. money centre banks already find themselves at a competitive disadvantage internationally. Our banks face a higher effective cost of capital, which is largely a result of the risk premiums demanded by the market. Some of the elements of this include:

- Our relatively higher exposure to LDC debt, compared with our European and Japanese competitors
- The macro budget deficit positions of governments in Canada and the U.S., resulting in significantly higher interest rates

- The interpretation and application of BIS capital requirements in competitor countries, such as Japan and the U.K., which are effectively less onerous, resulting in higher leveraging on the same discrete amount of capital

It is also worth noting that BIS capital requirements do not apply to the large U.S. investment banks, which have taken the place of many commercial banks in the provision of credit and capital to the large corporate market. The elements we have noted are not likely to change significantly in the near future and will continue to be a factor in the cost of capital. However, they can be offset to some extent by positive elements -- the most fundamental one, again, being a stable deposit base.

Conclusion

We believe the U.S. financial services industry is overly restrictive and overly regulated. Given that North American banks are already at a disadvantage because they face a higher effective cost of capital, the U.S. should remove other structural barriers that reduce their competitiveness.

We believe steps should be taken soon to eliminate the barriers that prevent commercial banks from underwriting securities, and the barriers that prevent them from engaging in interstate banking.

We believe the regulatory burden should be reduced, especially the paperwork added by overlapping areas of supervision, and that the strength of a foreign parent should be taken into account when examining its operations in the U.S. We also favour a move from an adversarial approach to regulation, to one of cooperation.

We believe the goal of deposit insurance reform should be to create a system that reinforces the discipline of the marketplace. No institution is too big to fail.

We believe maintaining independence between the financial and commercial sectors is of fundamental importance, and is in the best interest of depositors.

APPENDIX

Bank of Montreal in the United States

With assets of more than US$67 billion, Bank of Montreal is among the 10 largest banks in North America. It serves more than four million customers through its 1,200 branches across Canada and has offices in key financial markets and trading centres in 17 countries around the world.

Bank of Montreal has always had strong ties with the United States. Half of its initial capital was raised in New York and Boston. Its first representative in New York was appointed in 1818, just one year after its founding as Canada's first bank. It also has a long association with Chicago, where it opened an agency in 1861. Indeed, the Bank's presence in Chicago pre-dates the establishment of Harris Bank. Bank of Montreal was one of the charter members of the Chicago Clearing House Association, formed in 1865 to assist in cheque clearing and which served as the nucleus of a rapidly growing money market. Bank of Montreal's Chicago presence was, of course, considerably expanded with the purchase in 1984 of Harris Bankcorp.

Harris is a major presence in the midwest, ranking among the top 50 U.S. banks in terms of total assets, and among the top 20 in trust income and assets.

Chicago and, in particular, Harris were attractive to Bank of Montreal for a number of reasons: the natural proximity to Canada, the traditional links between Chicago and the Canadian heartland, and the enormous economic potential of a region whose gross domestic product is equal to 40% of the entire GDP of Canada. The growth in Canada-U.S. trade and investment made it essential, in Bank of Montreal's view, to have a full-service capacity on both sides of the border. From a defensive standpoint, as more foreign banks, and particularly American banks, established themselves in Canada, the Bank also saw a strong presence in the U.S. as a key to maintaining and enhancing our competitiveness in Canada.

In terms of Bank of Montreal's U.S. operations, business segments are targeted for coverage by that component of the Bank with the greatest expertise in a given area. For example, Bank of Montreal is strong in the fields of energy and commercial real estate lending, while Harris is better positioned to handle the U.S. large corporate and middle market commercial portfolio, and nationwide trust and cash management services. Bank of Montreal's branch banking experience will be invaluable in assisting Harris in the expansion of its affiliate banking network in Illinois, while Harris' trust experience will help guide Bank of Montreal as it is allowed to expand such services in Canada. Because of Bank of Montreal's greater capital position, Harris is also able to bid for loans which would otherwise be beyond its capability due to regulatory and house limits.

In the corporate banking sector, Bank of Montreal and Harris maintain offices in several U.S. cities including New York, Chicago, Houston, San Francisco and Los Angeles. Both banks provide treasury services nationwide in the U.S. market, with Harris having the exclusive mandate for the eight state region around Illinois. Both are also active in global custody services and correspondent banking. Harris Government Securities, a subsidiary of Bank of Montreal's U.S. bank holding company, is a primary dealer in U.S. treasury securities. The Bank is hopeful that, shortly, its Canadian securities subsidiary, Nesbitt Thomson, will receive approval for expanded Section 20 powers in the U.S., enabling it to begin dealing in corporate debt and equity securities.

The Canadian Bankers' Association

The Canadian Bankers' Association, established in 1891, is a professional association of the chartered banks, which seeks an understanding of the industry at all levels of government, and among interest groups, international bodies and the media. The Association contributes to the development of public policy on issues which affect member banks by co-operating with other organizations and associations to produce a sound, efficient financial system. To help accomplish these objectives, it provides its members with information, research, advocacy, education and operational support services.

- All banks in Canada become members of the CBA upon being granted their licence to operate as chartered banks. Currently there are seven Schedule I (domestic) banks and 57 Schedule II banks.
- CBA, with a staff of 106, headed by President Helen K. Sinclair, is headquartered in Toronto. Provincial offices are maintained in Victoria, Edmonton, Regina, Winnipeg, Ottawa, Montreal and Halifax.
- The President is the chief staff officer with membership on the CBA's Executive Council. Chairman of the Council (a two-year appointment) is P.C. Godsoe, Vice-Chairman, The Bank of Nova Scotia.
- All schedule I banks have representation on the Council, and Schedule II banks are represented by two members elected by them.

The **Chairman**. Thank you, Mr. Chisholm. I am tempted to ask what the latest polls are in Newfoundland at the moment because of the interest that we all have in that question, but I may leave that for later.

Before calling on Mr. Hale, let me also thank you for a very fine statement and a very well focused statement and a helpful one to us.

We have been joined by Senator Bryan, and as he has a chance to get seated, I would like to just inquire if there is an opening comment that you might wish to make or a statement that you might have for us.

Senator **Bryan**. Thank you very much, Mr. Chairman. I do not have an opening statement, but I look forward to an opportunity to question our panel.

The **Chairman**. Very good. Thank you very much.

Mr. Hale.

STATEMENT OF DAVID D. HALE, CHIEF ECONOMIST AND FIRST VICE PRESIDENT, KEMPER FINANCIAL SERVICES, INC., CHICAGO, IL

Mr. **Hale**. Thank you very much, Senator Riegle.

I would like to begin to begin by complimenting the committee for having these hearings. In view of the massive structural changes occurring in the world financial service, and in America's place in the international financial system, it's essential that we have a very comprehensive rethink of many of our regulatory policies and traditional ways of doing business.

Indeed, if we look at the structure of the financial service sector, we will see that the late 1980's is a period when we have had far more internationalization of the financial service than at any time since the end of the 19th century. This reflects not just technology, but also global savings balances. By 1994 or 1995 America's net foreign investment and debt ratio as a share of GNP will be as high as it was in 1895. Consequently it's not surprising that we have had a significant growth in the foreign share of our banking marketplace and now need to rethink our regulatory framework and our competitive position.

In your letter of June 5 you asked us to focus on five major sets of issues, and I thought I would use my 8 minutes this morning to examine the evidence in terms of those five issues.

The first question was one of comparing regulation, and here I would like to focus on the United States and Japan in particular because Europe and Canada have already been discussed quite adequately.

I think we have three major problems from an international perspective in the regulatory area when we make comparisons with the other industrial nations.

First is the sheer number of financial institutions in this country. We have 14,000 banks and several thousand S&L's and insurance companies. The structure of the other industrial nations is much more compact. The other industrial nations effectively have most of their banking assets concentrated in five or ten major institutions, and for many years have had de facto cartels, if not by law, certainly in terms of business practice.

Second, we also have multiple regulatory agencies compared to the other industrial nations. Typically in the other industrial nations you will find that the Central Bank or the Ministry of Finance plays the major role in regulating and supervising institutions. In this country we have a variety of regulatory institutions, both at the Federal and State level, and financial in the 1980's been a problem for us.

And, finally, I think we have suffered in the last decade from a deterioration in the quality of our civil service. As numerous officials have noted in the press, we did have in the 1980's a problem of compression in real pay for civil servants. We had a very high turnover among our bank examiners, and this I think impeded the ability of our regulatory institutions to be effective at a time of dramatic change in the structure of the system—at a time when we maintained deposit insurance for liabilities while allowing much more freedom in the way banks could deploy their assets.

In short, we had in the 1980's a policy of financial Darwinism that was not offset by adequate public sector supervision. There may be examples from time-to-time of overregulation and overreporting, but in terms of the overall supervision process, I think America failed very badly in the 1980's, and the scale of the S&L crisis demonstrates that.

When we go to Japan, we go to a very different kind of regulatory structure. Here we have both a cartel structure guiding the banking system and far more extensive Government controls. The Government still sets rules that for some categories of interest rates, the sectoral mix of growth lending and the ability of financial organizations to take risks and to pursue new kinds of activities.

In addition, I think it's important to remember that in the case of Japan the Ministry of Finance and the Bank of Japan command a tremendous amount of respect in the society. They have a much more comprehensive career program for training people and keeping them over several years and then for eventually redeploying them in the private sector.

And this kind of interaction I think has given them an overall regulatory advantage which is hard to quantify, but is important in understanding why Japan has been so effective in the modern period and is now developing large globally competitive banks and securities companies.

Indeed, I think you could argue that the Japanese have a philosophy that low profitability in a financial institution is a public policy problem because it will encourage irresponsible behavior to generate profits in new sectors which might be risky.

So I think regulation has been one of our problems and it requires a very significant rethink.

The second issue I was asked to address in your letter is the activities——

The CHAIRMAN. By the way, let me just say on that point, and you may be going to some recommendations in terms of an alternative regulatory structure, but I would welcome any of your thoughts beyond what you may have prepared today on that question. I think you raise a very important question, and I would like to have your thoughts on what might be a revised structure.

Excuse me.

Mr. **Hale**. Oh, fine. I'll come back to that later.

The second issue you asked me to address in your letter was the activities permitted to banks, the structure of the financial system. As previous speakers have indicated, the traditional dividing line in the modern period has been that the English speaking countries had a separation of commercial banking and investment banking. Japan had that as well in the modern period because of our occupation and the introduction of Glass-Steagall into Japan.

The continental European countries by contrast have had a long-standing tradition of universal banking because they industrialized later and therefore banks played a much more important role in the financial process the banks, for example, often had very cross-shareholding systems with the industrial companies.

The trend now obviously is towards universal banking. As you have indicated, previous Japanese speakers have told you there will be a movement towards universal banking in Japan over the next 2 or 3 years. The final rules are not yet out, but my impression from talking to Japanese bankers and bank stock analysts, is that we will have in the next few years a universal banking model in which Japanese commercial banks will be allowed to do equity underwriting and to be in the equity business with one office. Their equity business also will be focused on the institutional side of the business and not on the retail side of the business.

So there will be a convergence between banks and securities companies, but there will still be an attempt to maintain some compartmentalization.

In addition, the Ministry of Finance will continue to set brokerage commissions. There will not be the kind of free market in brokerage commissions that we currently have in Toronto, in New York and London. This policy will help to set some parameters for profits and to maintain some of the previous characteristics that allowed Japanese securities firms to have a higher rate of return than their foreign counterparts.

It's also unclear if MOF will allow a major change in the workings of the Japanese warrant market. In recent years a third or even a half of the profits in the Japanese stock broking business have come from the fact they have a fixed spread in the warrant market and don't have screen trading. And if this is allowed to continue it will obviously be very benign for the profitability of the securities companies and the banks going into the securities business.

My impression also is that securities companies will now be allowed to go into some of the businesses done by banks, such as foreign exchange trading, but they will not be extensively involved in banking compared to other countries where universal banking tradition is already in place.

The third issue you asked me to address are the links between the banking and the corporate sector and what role these had played in determining a banking system's financial competitiveness both domestically and globally.

Here I think we again have some very major contrasts between the United States and Japan and also Germany. In Japan there is an industrial group system, the Keiretsu, which includes a lead bank playing a role in the industrial group and typically having extensive cross-shareholdings. Indeed it's argued by stock brokers in Japan that anywhere from 50 to 70 percent of the stock of the major financial organizations are in stable hands, that is, other members of the industrial group as well as pension funds or insurance companies with links to the group.

As a result, it has been possible in the late 1980's for Japanese banks to raise a tremendous amount of equity capital, both in terms of straight equity and convertible debentures to comply with these new international settlement capital asset ratios.

Indeed, my research suggests they have raised about $50 billion of equity over the last 3 years to comply with these rules and have done it at share price multiples of 50, 60 and 70.

Now some of the differences in U.S. and Japanese share price multiples can be explained by accounting, but by any standard you want to use, Japanese banks have enjoyed a tremendous cost of capital advantage in the equity market compared to this country. They also have been to do it without changing their shareholding mix because of their unique cross-shareholding system.

The **Chairman**. Let me just stop you there for a minute. If I heard you right, the banks and these financial organizations raised $50 billion of capital in Japan in the last 5 years.

Mr. **Hale**. Three years.

The **Chairman**. In the last 3 years $50 billion, and with a very favorable price-earnings ratio being present. Do you have comparable data for the United States?

Mr. **Hale**. I don't, but the total capitalization of our bank stocks at the end of last year was about $110 billion compared to $500 billion for Japan. So if our equity capital funding exceeded $10 billion I would be surprised, but I haven't got a hard number to give you.

The **Chairman**. And of course you are just looking at new equity in, and I'm even wondering in terms of the losses that we have accrued over that period of time if we have had new equity increases in U.S. banks?

Mr. **Hale**. I would say for many of our major banks it has been equity erosion because of loan losses both in absolute terms and as a share of capital.

In addition, under the BIS ratios Japanese banks can include in their capital equity ratios a tier two of capital which include unrealized equity holding gains. As a result, the tremendous inflation in many Japanese asset prices during the last 3 or 4 years has made these organizations capital rich. Indeed, you have a kind of pyramiding going on where banks are stronger because of asset appreciation—then they expand their balance sheets further, generating new lending activity and asset inflation both in Japan and elsewhere.

It's no surprise that with the recent drop in the Tokyo stock market we have seen ripple effects in the real estate markets of Australia and Hawaii and New York. Investors fear that the weakness of the Toyko market will prevent Japanese banks from expanding their lending as aggressively as they were doing.

Let me just add that Japan's ability to control credit risk is also enhanced by its cross-shareholding system. Because companies often work together to solve their problems, that is, they have a kind of team work approach to business problems within an industrial group, lending problems or loan loss problems have not been as great a problem for the Japanese as they might have been for organizations in the United States or Britain, where you have a more free standing industrial structure, where you don't have extensive cooperation between businesses to control profits and to manage risk.

I think this is a major institutional difference in developing a competitiveness policy for America. We have no alternative but to recognize the fact that the financial and industrial structure of other countries differs quite radically from our own.

The fourth issue you asked me to address is the issue of deposit insurance. In the case of Japan they have had deposit insurance since 1971. Deposit insurance guarantees are for very modest sums of money, on 10 million yen. That's several thousand dollars or much less than the $100,000 investor that we have here.

But in looking at the Japanese approach to deposit insurance I think we have to focus again on some larger questions. Their structure of financial regulation is so different because of the traditional cartel approach and the much more extensive intervention by the Ministry of Finance either through written rules or through moral suasion. Deposit insurance itself simply hasn't been a major issue.

Would they let a major bank fail? Of course not. They would find some way to have the organization merge. They would not permit failures by numerous medium and small sized institutions to create expensive bail-out problems for the Government. There would be a private sector solution with the Government playing a moral suasion role behind the scenes.

Finally, you asked me to focus on the other issues that I thought might be important in developing a financial competitiveness policy. I would just summarize very quickly four major points.

As the committee itself has suggested here in its own debate about trade policy for financial services, we have to distinguish between de jure and de facto national treatment in looking at foreign marketplaces, recognizing that although nominal rules and written law may appear to conform to ours, the market reality is quite different because of differences in ownership structure and approaches to regulation, especially the use of moral suasion.

Second, you've asked me to discuss the issue of banking and commerce. We are now having a major debate about how we want to control corporations and what our form of corporate governance should be.

In the modern period we have had a stock market dominated form of capitalism, whereas, Germany and Japan have had a bank dominated form of capitalism, where companies and groups change managements by working together at the Board level as opposed to having hostile takeover bids in the stock market.

Needless to say, this is a very complex issue, but I think in looking at financial competitiveness we can't separate it from the issue of corporate governance and how we want to see our corporations organized vis-a-vis the financial sector in the 1990's.

And, finally, like all economists, I have to finish up by suggesting that one way to enhance our financial competitiveness, to improve our market share, is to have more pro-savings tax policies. Our banks do suffer from a higher cost of capital. Part of that reflects microeconomic differences, differences in ownership structure in America, Germany and Japan, but part of it also reflects our very low savings rate and our traditional fiscal bias towards consumption rather than savings, and there is no way we can have a comprehensive long-term solution to our competitiveness problem if we don't have a higher savings rate.

Thank you very much.

[The complete prepared statement of David D. Hale follows:]

PROMOTING AMERICAN INTERNATIONAL COMPETITIVENESS IN FINANCIAL SERVICES

Senate Banking Committee
Testimony for Modernizing the Financial Services Industry

David D. Hale
Kemper Financial Services, Inc.

June 20, 1990

SUMMARY

The globalization of the financial service industry will pose major new challenges for American policy makers during the 1990's. There is likely to be a dramatic increase in the foreign share of America's market for banking and other financial service products. American financial institutions will ask the U.S. government to develop trade and commercial policies for maximizing this country's competitiveness in banking, insurance, and securities trading. Because of the wide gap between Japanese and American bank capital costs, U.S. regulators may become concerned about Japanese banks engaging in "financial dumping" or offering loans and services at such cut rate prices that U.S. banks are forced to go after higher risk business in order to maintain profits.

There is no simple way to define America's comparative advantage and national self-interest in developing a trade strategy for the financial service sector. American banks have lost global market share during recent years in part because they have high capital costs. Those capital costs, in turn, are the by-product of domestic macro and microeconomic policies which have been favorable for U.S. consumers. Hence, it will be difficult to pursue an effective strategy for improving America's financial service competitiveness without modifying tax policies which enjoy popular support. If the U.S. were to pursue protectionist trade policies in promoting its financial service sector, it would probably also impede the flow of capital into this country, push up interest rates, and increase the danger of recession. As a result of these constraints, the development of an effective trade strategy for the financial service sector will require more than a general statement of concern from the nation's policy makers. They also will have to accept some potentially difficult tradeoffs in policy areas with important implications for national savings behavior, the structure of financial power in the United States, and the future relationship between banking and commerce.

The development of an internationally competitive financial service sector in the U.S. will require policy actions on several fronts.

First, the U.S. will have to permit the introduction of universal banking in order to provide American financial institutions with the flexibility enjoyed by their foreign counterparts. Although American banks are already active in numerous sectors of the securities industry, the U.S. will soon be the only major industrial country to prohibit banks from equity underwriting. The U.S. may also want to modify some of its traditional rules separating banking and commerce in order to provide alternatives to the stock market driven form of corporate governance which has characterized the U.S. in the modern era. There is some evidence that German and Japanese industrial firms benefit from the closer integration between banking and commerce which exists in those two countries. While no one has yet advocated that the U.S. consciously imitate the German or Japanese models of corporate governance, we may evolve towards a more bank dominated form of capitalism if state legislatures continue to pass laws restricting takeover bids in the stock market.

Secondly, the development of an internationally competitive U.S. financial service industry will require the creation of a higher quality system of domestic financial supervision than existed during the 1980's. Because of the erosion in American regulatory standards during the last decade, U.S. banks are now confronted with severe credit quality problems and increasing deposit insurance costs. In most other industrial countries, financial supervision has been more effective and their banks have fewer problems with both loan losses and deposit insurance costs. It is true that the U.S. government faces a more complex supervision task than some other industrial countries because of the large number of financial institutions in this country, but the breadth and diversity of the U.S. financial system merely underlines the need for an adequately funded and competent supervision system.

Thirdly, U.S. trade policies in financial services should be commercially sophisticated and sensitive to the realities of foreign marketplaces, not dogmatic and legalistic. The financial service sector was never covered by GATT. In the past, the U.S. has classified other countries's financial service trade policies on the basis of official rules, such as whether they conformed to our national treatment model or had reciprocity based access policies. While these concepts are useful from the standpoint of negotiating treaties, they provide little information about the realities of particular national marketplaces. In both Germany and Japan, for example, American firms have tiny market shares in financial services not merely because of official barriers; they are also blocked by a system of corporate cross shareholdings between banks and industrial firms which makes it difficult for foreign banks to gain entry. In the case of Japan, the U.S. is now trying to remove such microeconomic barriers to market access through the yen-dollar talks and the Structural Impediments Initiative. This strategy of gaining market share for U.S. firms through promotion of greater microeconomic convergence should be continued.

In addition to promoting microeconomic changes within Japan, the U.S. has developed a system of de facto managed trade in financial services with Japan. The U.S. share of Japan's commercial lending market is tiny, but during recent years Japan has attempted to provide American firms with access to special niches such as trust banking or to enhance the profit margins of U.S. brokerage houses by providing them with greater access to Japan's domestic broking cartel. While such discrimatory trade policies pose numerous long-term risks, the niche "offset" system which Japan has developed to compensate American firms for its unique market rigidities represents a useful transitional strategy for containing trade tensions until there is greater microeconomic convergence between the two countries. What remains unclear, though, is whether U.S. policy makers have done enough to maximize the value of the "trade offsets" which Japan is giving American institutions in order to compensate for the closed nature of of its traditional banking market.

Fourthly, U.S. policy makers should pay more attention to the structural impediments to trade in financial services which exist in the European marketplace. Germany has a corporate and bank cross shareholding system more similar to the Japanese model than the American model. As a result, it is often difficult for foreign financial service firms to penetrate the German banking market. In many European countries, there is also greater concentration of private savings in banks and insurance companies than in the United States. These structural differences in financial intermediation have made it difficult for U.S. firms to develop specialized niches comparable to those which are now emerging in Japan under the auspices of MOF's de facto managed trade policy for financial services.

Finally, the U.S. should not pursue trade retaliation policies in financial services which might inhibit the flow of capital into the United States. One of the most remarkable features of the world financial scene today is that the U.S. has lower real long-term interest rates than Germany and Japan despite its low savings rate. The explanation for Germany's high real bond yields is the cost of unification with the east. But in the case of Japan, there is strong evidence that the country's inflated equity prices and rigid asset markets are now self-correcting through large capital outflows, which are pushing up real bond yields. If sustained, this change in the relative cost of capital could help U.S. competitiveness and damage Japan's. As a result, the U.S. should use only selective sanctions on Japanese financial service firms, not broad investment restrictions, as a negotiating tool for improving U.S. access to Japanese goods and services markets.

* * *

INTRODUCTION

The international competitiveness debate which focused on America's goods producing industries during the 1970's and 1980's will spread to the financial service sector during the 1990's.

There will be growing public and private discussion of America's international competitive position in financial services because of both the rapid growth now occurring in the foreign market share of U.S. banking and the relatively weak position of U.S. banks in many foreign markets. It is also likely that policy makers will eventually come to recognize that the linkages between the banking and commercial sectors can have a major influence on other factors which determine a country's industrial competitiveness, including systems of corporate governance, the nature of the investment decision making process by private sector firms, and the development of industrial policy by the public sector.

This testimony will examine international competitiveness in financial services by focusing on five major questions. First, what are the current market share trends for the major players in global financial services? Secondly, what is the structure of the banking system in other major industrial countries and how does this structure affect their global competitiveness? Thirdly, how do other countries regulate their banking systems and guarantee the safety of deposits? Fourthly, what is the relationship between banking and commerce in the other major industrial nations and how do these differences affect their industrial performance? Finally, how important is the national savings rate to a country's cost of capital and financial competitiveness in an age of global capital mobility? The testimony then concludes with an examination of some policy options for improving the international competitive position of the U.S. financial service sector.

MARKET SHARES

During the past five years, there has been a dramatic increase in the foreign market share of the U.S. commercial banking industry as well as a significant growth in the presence of foreign investment banks in the American marketplace. According to a recent newsletter from Wells Fargo Bank,

> *"In the past year, alone, loans on the books of large [foreign] branches and agencies have risen more than 14%, nearly triple the growth at U.S.-based banks. Those increases translate into further gains in market share. By the end of 1989, foreign banks' branches and agencies controlled over 16% of all assets in the U.S. banking system, up from 15.5% in 1988 and little more than 11% as recently as 1985. Adding the commercial bank subsidiaries of foreign banks (such as Marine Midland and Union Bank) raises that share to more than 20%. That presence is dominated by Japanese institutions, which account for nearly 55% of all foreign bank assets in the U.S.*

> *Even those figures understate the full extent to which foreign banks have penetrated several key markets. Drawing on the large capital base of their parents, U.S. agencies and branches of foreign banks boosted their standby letters of credit (or L/Cs) to $186 billion at the end of last year, or over 51% of the market. Standby L/Cs are issued as backing, or credit enhancement for commercial paper, municipal securities and other issues. Including their U.S. subsidiaries, foreign institutions also account for nearly 30% of all outstanding business loans by commercial banks, including an even more imposing 60% of all such loans on the books of banks in New York and 49% in California -- the two states in which foreign banks are most active. Branches and agencies, alone, account for 46% and 35%, respectively, of the business loans in those two markets."*

Global data also shows a dramatic erosion in the relative position of American banks. According to a survey done by the American Bankers Association using 1988 balance sheet data, the largest U.S. bank (Citicorp) now ranks only 12th in size among the world's leading banks. The ten largest banks in the world are Japanese while five of the next ten slots are filled by French and British banks. Germany's largest bank ranks 22nd. National differences in the stock market capitalization of banks are also impressive. At year end 1989, Japan's top thirteen banks had a stock market capitalization of $470 billion compared to $110 for America's top fifty banks. Since December, the capitalization of Japan's major banks has fallen by about 20% but America's bank stocks also have lost nearly 10% of their value.

If we compare banks on the basis of asset returns, though, the growth of Japanese banking power appears less impressive. In 1988, none of Japan's banks ranked among the world's ten most profitable on the basis of asset returns. This suggests that Japanese banks have either been winning market share at the expense of profit margins or that they have been less successful than other institutions in developing fee oriented business lines.

Japan's securities firms have also emerged as important forces in global underwriting during recent years. Ten years ago, the top 20 Eurobond underwriters did not include any Japanese firms. In 1988, each member of the big four was in the top 20, as was the Industrial Bank of Japan. In contrast to Japan's banks, Japan's securities firms have been highly profitable during recent years. In the year ending March 1990, Nomura reported recurring profits of 489 billion yen ($3 billion), making it the second most profitable company in Japan. In the U.S., by contrast, anaylysts estimate that the top twenty five securities firms had only about $2.3 billion of profits last year. Japanese securities are highly profitable for a mixture of regulatory and commercial reasons. Tokyo equity prices have been in a major bull market for nearly a decade. Commission rates are still fixed, although subjected to periodic adjustment by the MOF. The Japanese warrant market has emerged as a lucrative source of profits because warrants are traded without screens on the basis of bid and asked quotes placed over the telephone. What now remains to be seen is how the recent shake-up of the Tokyo market will affect the profitability of warrant trading as well as turnover levels in the equity market itself. Some analysts are forecasting that Nomura's profits could drop by 40-50% in fiscal 1990-91.

BANK STRUCTURE

In the 1930's, the U.S. Congress enacted legislation separating the functions of commercial and investment banking. In the modern period, other English speaking nations also have tended to pursue regulatory policies which maintained a clear separation between commercial banking, investment banking, and stock broking. During the post-1945 American occupation, Japan switched to the American system of banking as well. In continental Europe, by contrast, countries, such as Germany, have a long established tradition of universal banking. Under the universal banking system, banking institutions provide a more comprehensive range of services, including commercial loans, equity underwriting, and specialized forms of merchant banking. Because of the role which German banks play in providing long-term as well as short-term finance, it also is commonplace for them to have large shareholdings in commercial firms and to play a management role through control of board seats. As a result of the dominant role which Germany's banks have played in financing corporations since 1945, the German stock market is much less developed than the stock markets of the English speaking countries. In 1987, it had only 514 listings compared to 2135 for London, 1174 for Toronto and 650 for Paris. The German ratio of equity market capitalization to GNP is also less than 30% compared to over 50% in the United States and 80% in Britain while only ten companies account for half of all stock market turnover. Finally, the growth of pension funds in Germany has lagged behind the U.S. and Britain. At the end of 1983 the portfolios of West German pension funds and insurance companies contained only 2.5% of the value of German equities compared to 40-60% in most English speaking countries.

In the 1990's, there is likely to be a greater blurring of the distinction between the American, Japanese, and European financial systems because of changes now occurring in both regulatory rules and financial market conditions.

In Japan, it appears likely that commercial banks will be permitted to develop investment banking subsidiaries while the securities firms will probably be permitted to engage in several activities now reserved for banks, such as foreign exchange trading. Many Japanese banks have prepared themselves for this change by developing close shareholding and business links with small and medium sized brokerage houses. In fact, the banks are already recycling some of their personnel into these brokerage houses. Meanwhile, the Japanese stock market itself is emerging as a much more important conduit for capital formation than it was previously. In 1988 and 1989 equity oriented fund raising was equal to 4-5% of GNP compared to only 1% in much of the 1970's. Analysts also project that there will be a dramatic growth in the size of Japanese pension fund assets during the 1990's. Until recently, the largest source of institutional savings in Japan was insurance companies.

In Britain, commercial banks were permitted to enter the securities business in the mid-1980's. A similar trend also has occurred in Australia and Canada. Many continental European banks have opened up large securities trading operations for both debt and equity in London as well. In Germany the securities industry continues to be dominated by the universal banks as well as a variety of smaller banks. What remains unclear is whether the stock and bond markets will emerge as more important channels of financial intermediation in Germany. There has been modest growth in the stock market during the 1980's, but German firms have generally been content to rely upon traditional banking relationships. Although Germany had a large and active stock market in the late 19th century, it has not redeveloped an equity culture in the modern period. In fact, a large share of the trading in German debt and equity instruments now occurs in London because it has more aggressive market makers as well as lower transaction taxes. Because of the capital needs which will be created by the unification process, it is possible that the German stock and bond markets will now become more important. But because East Germany itself has no modern tradition of capitalism, bank finance is likely to remain relatively important. Indeed, many economic historians have long argued that bank finance was far more important in German economic development than in Britain because Germany industrialized much later. These same arguments may now be applied to East Germany.

Many American bankers contend that Glass Steagal is a significant barrier to American international financial competitiveness because foreign banks can offer a wider menu of products and services while the high cost of bank equity capital in the United States makes it expensive for domestic banks to expand their balance sheets through traditional forms of lending. As a result, they want the U.S. to follow Britain in permitting the development of universal banks, offering both commercial and investment banking services.

The arguments against Glass Steagal are valid. American banks do have fewer powers than many foreign banks. The high cost of equity capital in the U.S. makes it difficult for them to expand through traditional channels, such as commercial lending. But three factors suggest that repeal of Glass Steagal will have a far less dramatic impact on American bank competitiveness than one would think from the amount of attention which has been devoted to the issue during recent years.

First, U.S. banks already have the power to underwrite most forms of debt. Hence, they can already play a major role in securitized forms of lending. In fact, there is a rapidly growing secondary market today in bank loans, not just bonds and commercial paper.

Secondly, some U.S. banks expanded into the international equity business during the 1980's and found the going much tougher than they initially expected. As a result, banks such as Citicorp, Security Pacific, and Chase Manhattan have already sharply curtailed their overseas equity operations. It could be argued that they would have performed better in foreign equity markets if they had been operating from a strong domestic base, but the fact is the American equity business has not been very profitable during recent years either. Commission rates have fallen to low levels and many U.S. securities firms have cut back their market making activity. Hence, it is difficult to believe that American commercial banks will become large and aggressive players in the equity business even when Glass Steagal is fully repealed.

Thirdly, the German experience with universal banking raises a number of provocative questions about whether U.S. banks will be anxious to promote the use of the equity market as a source of capital when they enjoy a good lending relationship with a firm. According to recent research by the Center for European Policy Studies, the universal banking system has greatly retarded the development of German's stock market. The study reported that,

> *"In spite of the actual worldwide tendency in favour of universal banking the picture that emerges from theoretical considerations and the actual experience of Germany is mixed. Universal banks are said to enjoy advantages from economies of scale, economies of scope and from the possibility of reallocating resources internally in response to demand trends. Empirical verification of these alleged advantages is extremely difficult and to date no conclusive evidence exists.*
>
> *On balance, we arrive at the conclusion that the alleged advantages of universal banking tend to be overemphasized. Economies of scale are not an outstanding feature in banking and where they exist they can be better exploited by specialized firms (e.g., payments systems, investment banking). For example, computer systems do generate important economies of scale. But they need to be designed specifically for payments systems, loan processing, securities analysis, etc. Hence, although economies of scale exist for some areas of banking there are no positive economies of scale for a widely diversified bank. Hence, economies of scale are a weak justification for universal banks."*
>
> *"What the German experience shows is that the major historical reason for universal banking, namely provision of long-term financial resources to economy in the absence of well-developed securities markets, is not a decisive consideration anymore. Furthermore, the market power of universal banks needs to be checked by competitive conditions both among universal banks and through specialized institutions. This concern is weighty in small protected markets but less so in a well diversified European market. Our view is that specialized institutions will remain highly competitive through excellency and scale economies so that there will be no scope for some universal banks to dominate the market.*
>
> *In addition, internationalization of specialized firms appears considerably easier than of universal banks. It would be a formidable challenge for a specialized national bank to develop simultaneously into an*

> *international and universal bank. Even after 1992 Europe will retain national characteristics and therefore organizational and managerial integration of a European universal bank seems quite difficult. The objectives of an integrated corporate culture and adaptation to different national markets are bound to create conflicts. Nor is there scope for marketing a universal bank brand name throughout Europe and thereby achieve economies of scale. Whilst the name of a reputed German bank has household value for a German customer it may not exert the same attraction in foreign markets. In line with this observation acquired foreign banks tend to retain their names."*
>
> *"Finally, we have attempted to assess some of the economy wide gains or inefficiencies (externalities) that may derive from a universal banking system. Such a system is prone to contribute significantly to restricted efficiency of the market for corporate control. As a result the allocation of resources in a modern economy requiring drastic corporate and sectorial reallocations, is not subjected to close efficiency monitoring. It give incumbent corporate managers excessive discretionary freedom, unhampered by shareholder control or by contesting outside raiders. Free internal cash flow in banks and non-banks can therefore be used in ways not compatible with value maximization. Two results follow: inefficient static resource allocation and reduced and inefficient investment patterns. Because it does not provide access to free cash flow, equity ownership outside of the control group is less attractive. The underdevelopment of German securities markets can thus be seen to some extent as a consequence of a financial system that is anchored in banking.*

The contrast between the post-war evolution of the financial systems in Germany and Japan also raises a number of interesting questions. Would Japan have developed a large and active stock market if it had retained a universal banking system after 1945? Did the creation of a totally independent Japanese securities industry after World War Two encourage the development of specialized skills which are contributing to Japan's emergence as a financial power house today? It is true that the stock market played a minor role compared to the banks in financing Japanese economic growth during the first three decades after World War Two, but the role of the stock market might have been even smaller if Japan had not had independent securities firms.

In summary, there is no doubt that repeal of Glass Steagal would enhance the global competitiveness of U.S. banks, but it is far from clear that they will find the equity business as attractive as they might have imagined in the past. It also is unclear whether the development of universal banking in the Anglo Saxon countries will be as positive for the growth of stock markets as a regulatory system which separates commercial and investment banking. Because of developments in information technology, the distinction between the two functions was eroding without any regulatory assistance, but there are still sufficient differences in business culture and leadership styles as to raise questions about how stock markets will fare under a globalized system of universal banking. As a result of these constraints on the future role of stock markets and the ability of banks to be effective players in the equity industry, the international competitive position of the U.S. financial service sector is likely to more profoundly influenced by how public policy evolves in areas other than Glass-Steagal, such as the quality of U.S. banking supervision and future trends in U.S. savings behavior

BANKING REGULATION

Until recently, the banking industry in most countries resembled a utility. The government used controls over deposit yields and asset mix to establish cartel like parameters for price competition and risk taking. In the 1980's, by contrast there was a global movement towards financial liberalization which exposed banks to far more intense competition than ever before. A variety of factors drove this process. There was widespread public resentment against official interest rate ceilings which held deposit yields below the inflation rate. In countries with commercial paper markets, it was often possible for high quality corporations to borrow money at a lower rate than their banks. In many countries the cartel like nature of the banking industry also tended to encourage low levels of labor productivity relative to other service sectors.

The pace of financial liberalization varied greatly from country to country during the 1980's. It proceeded most rapidly in the English speaking countries. It occurred much more gradually in continental Europe and Japan. As a result, it is not surprising that the greatest excesses in corporate and consumer borrowing during the past decade have occurred in the English speaking countries. As Anglo-Saxon financial cartels eroded, both commercial banks and securities firms felt compelled to compete much more aggressively for business. In the United States, this competition often went to reckless extremes because financial liberalization was not accompanied by the development of effective bank supervision. Banks and thrifts were able to expand their balance sheets at a frantic pace by bidding for deposits at yields which required the purchase of risky assets. Meanwhile, the intense competition for deposits eroded the profits of financial institutions adhering to more prudent lending standards.

Although financial liberalization encouraged imprudent lending behavior in Australia, Canada, and Britain, not just the United States, the scope of the regulatory problem was far greater here than elsewhere because of the unique structure of America's financial system and this country's historical animosity towards strong central government. First, the U.S. has thousands of independent banks, thrifts, and insurance companies compared to a few dozen in each of the other big English speaking countries; hence, the U.S. government faces a more awesome regulatory task than any other industrial country. Secondly, the U.S.

does not accord its civil servants a very high status either in terms of social status or pay. As a result, there was a significant erosion in the quality of America's financial regulatory agencies during the 1980's. According to press reports, staff turnover increased and experience levels fell despite the need for more sophisticated supervision to cope with the effects of deregulation. Finally, the geographic fragmentation of the U.S. banking system has rendered it more vulnerable to microeconomic shocks, such as falling prices for oil or agricultural commodities. If America had had a nationwide bank branching system comparable to the systems which exist in Canada or Britain, the profits earned by branches in prosperous regions would have been able to offset the losses of branches in regions with serious economic problems. Indeed, it is instructive to note that Canada began a movement towards independent regional or provincial banks twenty years ago but it ceased abruptly in the mid-1980's because falling commodity prices and eroding real estate values produced loan losses which wiped out the new institutions in its western provinces.

America's financial regulatory institutions and traditions also make for a striking contrast with Japan's. Although America's national banking system served as the initial model for the development of Japan's banking system during the Meiji restoration, the two countries evolved very differently after the late 19th century.

First, Japan has a mixture of national and regional banks playing distinctive roles in the financial system. According to a recent study of the Japanese financial system, by Sato, Ramachandran and Kong,

> *"The commercial banks followed the European than the British pattern and played an important role in providing long-term industrial funds. The number of banks increased to attain a peak of 1867 in 1901 and then declined rapidly. The minimum bank capital requirement of the Bank Law of 1927 disqualified half of the 1400 banks then existing; most of them preferred amalgamation with other small and medium sized banks. This brought about the dual structure in Japanese banking with the city banks concentrating on providing to national corporations and international commerce and regional banks serving the rest of the country."*
>
> *On the basis of historical origin, the city banks can be divided into four distinct groups [Bronte (1982)]. In the first group are four major zaibatsu banks that had a dominant role in the Japanese economy till the end of Second World War; they are Sumitomo Mitsui, Mitsubishi and Fuji. Six city banks -- Sanwa, Tokai, Toiyo Kobe, Kyowa, Daiwa and Saitama -- were formed by amalgamation of regional banks. Dai-ichi Kangyo and Hokkaido Takushoku were the products of privatization of state banks during the US occupation. Finally, the Bank of tokyo began as Yokohama Specie Bank, half owned by the Emperor, and changed its name after the end of the war.*
>
> *Legally there is not a distinction between city banks and regional banks. They perform all the functions permitied under the Banking Law but they have developed over time certain special functions. City banks act as 'main banks' for large corporations with whom they maintain close relation. The loans to the corporations are technically short-term but they are regularly renewed and so are in effect long-term. In addition they are among the largest holders of securities of different maturities. They also assist corporations in time of difficulties.*
>
> *"The regional banks are based on a prefecture though they frequently extend their activity to neighboring prefectures. The increasing economic integration of the country since the Second World War has*

> *provided an inducement to the regional banks to expand their activities to the big cities like Tokyo and Osaka. The regional banks provide services to the local enterprises and to local governments. They are important suppliers of funds to the money markets."*

Secondly, Japanese banks typically belong to larger industrial groups (Keiretsu), in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices.

Thirdly, Japan has at the core of its financial regulatory system two powerful and highly respected public agencies, the Ministry of Finance and the Bank of Japan. As the Sato paper explained,

> *"The Ministry of Finance acts as the Japanese equivalent of the US Treasury, the Securities and Exchange Commissions and the state banking commissions. In so far as it has oversight over the deposit insurance system, it also has some of the supervisory powers of the Federal Deposit Insurance Corporation. The bulk of the Ministry's authority comes form the Banking Law which permits it to license and supervise all banks. It has powers to approve or deny mergers, acquisitions and other changes in the operation of the bank including the opening of new branches.*
>
> *The Ministry can enforce its policies in two ways. It can issue an 'administrative guidance' either orally or written; given the extensive powers the Ministry of Finance have, the administrative guidance is universally obeyed even though it is not legally binding. Most of the supervisory powers rest with the Banking Bureau but the international operations of a bank are under the oversight of the International Finance Bureau.*
>
> *The Bank of Japan was established by an act in 1882; some scholars contend that it was modeled on the National Bank of Belgium though Goodhart (1988, p.150) questions it. It undertakes all the standard micro- and macro- functions of the central bank. Its discount rate is the reference point for most interest rates in Japan; in 1981 the Bank introduced the new lending facility similar to the Bundesbank's Lombard rate.*

Finally, Japanese regulatory agencies have administrative guidance instruments available to them which are much stronger than their counterparts in the U.S. and Europe, including direct controls on bank lending as well as various categories of deposits yields. These controls are now eroding due to financial market liberalization, but Japan's authorities are still able to use moral suasion far more effectively than their American counterparts. Because Japan uses far more controls and administrative guidance to supervise its banking system than the United States, it did not develop deposit insurance until much later. As the Sato study explained,

> *The Deposit Insurance Corporation was established in 1971 and was originally capitalized at 450 million yen of which the government, the Bank of Japan, and the private financial institutions each contributed one-third. Regular deposits, installment savings and money in trust with principle guaranteed, are*

> *covered by the insurance originally to an amount of 3 million of yen. Interbank deposits and deposits of Japanese branches of foreign banks are not covered. Until 1988, the Corporation charged a premium of 0.008 percent of the insured deposits during the previous year. It can also borrow up to 50 million yen from the Bank of Japan with the permission of the Ministry of Finance.*
>
> *On the recommendation of the Committee for Financial System Research that the deposit insurance system should be strengthened to maintain orderly credit conditions in the face of financial deregulation, the following revisions were made in May 1986; (1) The protection per depositor was raised to 10 million yen; (2) the premium was increased to 0.012 percent of the deposits; and (3) the limit on the borrowing from the Bank of Japan was increased to 500 million yen and the Corporation was allowed to borrow from other financial institutions to repay the loans to the Bank.*
>
> *The system was tested when the Heiwa Sogo Bank ran into problems in 1986 and had the potential of being the first bank failure in fifty years. Sumitomo Bank agreed to absorb all the uncollectible loans estimated to 170 billion yen. Thus, in contrast to the rescue efforts in United States in recent years, neither the Bank of Japan nor the Deposit Insurance System suffered any loss. However, the difference may be due to the 'shadow price' that Sumitomo Bank attached to the branches of the Heiwa Sogo Bank."*

In addition to the MOF's strong regulatory powers, Japan has tried to enhance bank safety during recent years by agreeing to the Bank for International Settlements' capital adequacy standards. Under these guidelines, Japanese banks will have to achieve equity/asset ratios of 8% by 1992 compared to numbers in the 2-3% range as recently as the mid-1980's. Japan's regulatory authorities did not initially welcome these new rules; they were imposed on Japan by the international community partly because of perceptions that low capital/asset ratios gave Japanese banks an unfair competitive advantage in seeking market share. Japanese banks do not feel they need high capital ratios because many of their loans are to companies which belong to industrial groups in which they have large cross shareholdings. Japanese banks also have large unreported holding gains on their equity portfolios and real estate assets. As a result, Japan agreed to adhere to the BIS rules only on the condition that its banks be permitted to include 45% of their unrealized holding gains on land and equities in their second tier of regulatory capital.

In the first three decades after World War Two, it was relatively easy for Japan's authorities to retain tight control over the financial system. Domestic capital was scarce; the export of capital was prohibited; financial intermediation occurred through a variety of specialized institutions whose operations were carefully monitored. Since the early 1980's, Japan's regulatory authorities have been confronted with a rapidly changing financial environment. Japan now has a savings surplus and is exporting capital on a large scale. Under pressure from the United States and various domestic interest groups, interest rate controls are being phased out. Corporations are increasingly able to satisfy their capital needs outside of the traditional banking system through channels such as the commercial paper market and the bond market. These changes pose a number of provocative questions about the future safety and stability of the Japanese financial system. Will the erosion of cartel pricing in the banking industry encourage reckless competition in lending practices and thus reduce the quality of bank assets? Will the MOF and the BOJ intervene through tough supervision to prevent such competition from producing large loan losses? Will Japan's small credit associations (Shinkin banks) be able to develop a book of floating rate assets in order to match the growth of deposit liabilities with uncontrolled yields? Will the growth of securitized lending (commercial paper, bonds) so alter the position of banks in the Japanese economy that they become relatively more dependent on foreign business and thus vulnerable to shocks beyond MOF's control? Will the entry of banks into the securities industry depress brokerage commissions and weaken the competitive position of the existing securities firms?

History suggests that Japan will adapt to financial deregulation far more successfully than the United States during the 1980's. Despite complaints from the United States Treasury, the Ministry of Finance is deregulating deposit yields far more slowly than this country did during the early 1980's in order to give backward institutions time to adapt to the new rules. The MOF also is reducing brokerage commissions at a gradual pace in order to prevent a competitive blood bath in the securities industry. Although Japan's financial regulatory framework is becoming more market oriented, Japanese authorities appear to understand the moral hazard problems created by low profitability in private financial institutions when the government provides an implicit safety net for deposits. This tradition suggests that Japan's regulatory agencies will still be able to employ administrative guidance on a discrete and selective basis when conditions warrant. While the quality of financial regulation has not played a major role in discussions of international financial competitiveness, there should be no doubt that the inferior quality of America's system of financial supervision has damaged the country's bank competitiveness. First, domestic bank profits have been eroded by reckless competition in both deposit gathering and lending practices. Secondly, there will now have to be large increases in taxation or deposit insurance premiums in order to pay for the bail-out of the public sector's deposit insurance system. These insurance costs also will be much higher in the U.S. than those paid by banks in Europe or Japan. Thirdly, because of reckless lending practices, many large American banks now have low credit ratings by international standards and must therefore pay a high price for both debt and equity capital.

BANKING AND COMMERCE

The English speaking countries have traditionally maintained a clear separation between banking and commerce. Although commercial and industrial firms provide selective financial services, they do not have access to deposit insurance. Meanwhile, American and British banks do not typically maintain equity shareholdings in commercial and industrial firms except in special work-out circumstances.

In both continental Europe and Japan, by contrast, it is far more commonplace for banks and industrial firms to maintain extensive cross shareholding networks. These networks, in turn, blur the distinction between bank lending and permanent capital for non-financial firms. Because the banks and the non-financial firms have such close relationships, the firm knows that it can regularly roll over its loans. The cross shareholding system also means that banks frequently play a more active role in the development of corporate business strategies than they do in the United States.

In Japan, these bank-commerce relationships typically occur within the framework of an industrial group. In theory, Japanese banks are not supposed to own more than 5% of a firm's equity, but the overall cross shareholding network within an industrial group often exceeds 20% of each members equity. If friendly insurance companies and trust banks are included, more than half of a company's equity is often in "stable hands".

In Germany, banks influence firms in two ways. First, they have direct shareholdings. Secondly, they often control the proxies of other shareholders. As a recent study of German universal banking explained,

> *"The proportion of voting rights controlled through direct holdings is quite small, around 5% of the top 100 companies (Monopolkomimission, 1978). Greater voting power accrues to the banks from the exercise of proxy-voting. When proxies are added, the overall proportion of votes in the tope 100 companies controlled by banks rises to 36%. Because small investors deposit their shares with banks and tend to invest in large and well known companies, proxy votes exercised by banks rise with the size of companies. For the ten largest companies the average proportion of votes controlled by banks exceeds 50%."*

> *"In th mid-1970's banks held 145 seats on the boards of the 100 top companies, or 10% of the total, and supplied 20 board chairmen and 6 deputy chairmen. Of the 145 seats 94 belonged to the 'big three' universal banks. By 1988 the board seats held by private banks of the top 100 corporations fell to 104 and those of all banks and insurnce companies to 161(10)."*

Although there is some public pressure in Germany to reduce bank influence over the corporate sector, it will be difficult to do so unless other entities can absorb their shares. Moreover, there is some evidence that the development of new high technology industries in Germany may increase the management influence of the banks rather than diminish it. The Deutsche Bank, for example, owns 29% of Daimler Benz and played a major role in that company's decision to become German's flagship company in the aerospace industry. In the case of the U.S., the Deutsche Bank-Daimler relationshp would be somewhat akin to Citicorp owning a third of Ford and encouraging it to merge with Lockleed in order to develop a new U.S. player in the global aerospace industry.

How do the strong relationships between banking and commerce in Germany and Japan affect the international competitiveness of their financial service industries? They have at least two major consequences. First, in the case of Japan, it has been possible for the country's leading banks to raise over $50 billion of new equity since 1987 because they have strong and stable shareholding networks. This access to cheap equity capital has given Japanese banks a major advantage in complying with the new BIS capital adequacy requirements. German banks also have engaged in a large amount of equity fund raising without depressing their share prices, but their p/e multiples are well below Japan's. Secondly, because of the close ties between banks and industry, it is more difficult for foreign banks to penetrate the Japanese and German lending markets. Banks and industrial companies in Germany and Japan do not measure the return from their cross shareholdings solely on the basis of dividends or capital gains; they also view their shareholdings as a mechanism for enhancing business relationships. Such arrangements automatically impede the ability of outsiders to gain access to market niches within the group for a wide range of products, including financial services.

Some analysts also contend that bank dominated shareholding systems have given a significant boost to German and Japanese industrial competitiveness by permitting their firms to operate with more stable sources of capital then are possible in the English speaking countries. According to these commentators, the stock market based financial systems of the Anglo-Saxon countries encourage short-term thinking and thus damage industrial competitiveness whereas the German and Japanese systems permit firms to ignore fluctuations in share prices and focus on winning market share through long-term investment strategies.

Needless to say, there is considerable controversy among both academics and businessmen about the relative merits of the two different forms of capitalism. Supporters of the German and Japanese systems contend that America's wave of takeover activity during the 1980's was a purely financial phenomena which will do little to help industrial competitiveness. Others contend that takeover activity is essential to purge the U.S. of weak managements and companies with poor strategies. More than likely both systems have merits which are conditional upon the circumstances of a particular industry. In old and mature industries, takeover activity is a potentially useful way to free up resources for other sectors. Conversely, the development of a complex and expensive technology may well require the kind of financial patience and ownership stability which only a bank or industrial group is capable of providing.

In an unpublished paper on "Finance-Industry Linkages and Exchange Rate Policy in the United States, Japan, and Germany", Randall Henning of the Institute For International Economics also drew attention to the effects of the Japanese and German cross shareholding systems on the conduct of macroeconomic policy in those two countries. According to Henning, the close relationship between banking and commerce in Germany and Japan has made their banks more effective lobbyists for exchange rate policies supportive of industrial competitiveness than American banks have traditionally been. He said,

> *"These national patterns in exchange rate policies over the postwar period coincide vary closely with differences in private sector preferences as defined by the relationship between finance and insutry within each country. In both Germany and Japan, banks have traditionally been directly and deeply involved in the economic prospects of industrial corporations, and therefore in the international competitiveness of these companies. Both countries have had credit-based financial systems in which banks have served as the primary sources of industrial capital for development and have regulated coporations' access to equity and bond markets. Banks' dependence on national industry has driven them to seek substantial power in the management of these firms.*
>
> *The United States, by contrast, has traditionally had a capital market-based financial system, in which the banks play a very different role. American industrial firms rely primarily on equity and bond markets to meet long-term financing requirements for investment and expansion. Corporate access to the capital markets bypasses the banks through nonbank intermediaries, 'investment banks.' Firms have a much more arms-length relationship with the major banks - which do not participate in corporate management - and borrow from them for relatively limited purposes of short to medium-term financing.*
>
> *As a consequence, whereas the Japanese and German financial sectors are tightly bound to the fortunes of their respective industrial sectors in international competition, the U.S. financial sector is, if not entirely divorced, much more loosely tied to American manufacturing. There is therefore greater unanimity within the private sector as a whole in Japan and Germany on the desirability of a low-valued currency than within the U.S. With management responsibilities in industrial corporations, German and Japanese banks are more likely to act as partners with industry in pressing these preferences on their respective governments than are American banks. . ."*
>
> *"Why should banking's stake in industry bear independently on exchnage rates policy determination?*
>
> *There are several reasons. First, while fostered by the developmental objectives of the state, the bank-industry connection in Japan and Germany creates a private sector more unified on exchange rate matters. Domestic-based, tradeable goods manufacturing has an unambiguous interest in a competitively valued currency. Banks on the other had have an ambiguous interest in the external value of the currency. During the 1980s, for example, U.S. banks benefited from the growth for foreign exchange trading business. On the other hand, exchange volatility and misalignment complicated credit analysis problems for U.S. banks and reduced the value of foreign earnings. As a result, bank CEOs were by and large agnostic toward the strong dollar. But close financial and ownership ties to industrial corporations engaged in international trade give the banks a shared interest in low-valued currencies. Such ties, therefore, broaden the coalition in favor of a competitive exchange rate.*
>
> *Second, bank-industry ties ease the task of preference formation in the private sector on international economic issues generally and the coherent articulation of those preferences to responsible officials in the government. Because the effects of the exchange rate might be diffused across many sectors or companies, and private sector organizations might not readily elevate the issue high on their agendas, the simplification of interest aggregation is important. This is facilitated by high concentration among firms in the banking and traded-goods sectors, as in Germany and Japan.*

> *Third, and most importantly, close bank-industry ties create new channels of access to the exchange rate policymaking process. Finance ministries and central banks are typically more responsive to policy advocacy and interest group activity on the part of the financial sector than other sectors of the economy. Because these agencies both regulate financial institutions and use them to finance and distribute government debt, they must remain sensitive to the health and needs of banking institutions and the financial sector generally. The official (finance ministries and central banks) and private financial sectors share economic priorities and a professional ethos, and they exchange senior personnel. Industry's combination with finance therefore provides entry to precisely those institutions responsible for setting exchange rate policies.*

The Japanese system of banking and corporate cross shareholding evolved under historical circumstances quite different from the United States. There was considerable public sector intervention to close the technology gap with the west during the 19th century. Japan had a shortage of capital after the war which enhanced the ability of the financial authorities to conduct an industrial policy through credit allocation. The Japanese do not harbor a populist suspicion of centralized authority and large commercial banks comparable to that which has frequently recurred in American history. As a result, it would be difficult for the U.S. to develop a bank anchored system of corporate governance even if everyone agreed that it was a good idea. But, ironically, the growing public hostility in this country to the stock market driven system of capitalism may force the Congress to consider modifying the traditional rules governing the relationship between American banking and commerce. During the past year, numerous state legislatures have passed laws which will severely restrict takeover bids for companies within their domicile. While some of this legislation may provide a useful check to the Wall Street excesses of the 1980's, it also creates some potentially serious problems for the American form of capitalism.

If the U.S. permits its states to pursue financial regulatory policies which discourage hostile takeover bids in the stock market while Congress restricts the ability of banks to guide corporate managements through cross shareholdings, the country could end up producing a new and rigid form of corporate control even more adverse to its industrial competitiveness than the current structure. In any capitalist system, there has to be a mechanism for removing poor managements and changing ill-conceived business strategies. In Japan and Germany, this is done by banks and industrial groups through boardroom discussion and inter-firm management consultations. In the U.S., it is the stock market which often serves as disciplining force. If a company performs poorly and the share price falls, there can be a bid for the company. The major defect of the U.S. system is that institutional investors do not usually play a consultative role with management comparable to that played by banks and group firms in Japan or Germany. If institutional investors dislike a firm's strategy, they sell the stock and the price falls until a raider appears. As a result, the stakes for employees in a U.S. corporate failure are often much higher than would be the case for employees in Germany or Japan. As the anti-takeover legislation now moving through state legislatures will testify, many Americans feel the cost of corporate adjustment in a stock market driven system of capitalism is socially unacceptable, but if the U.S. is to curtail the stock market's role as a controller of corporate management it has to replace it with something else. In the modern world, the alternative forms of discipline have tended to be either banks or industrial groups comparable to Japan's Keiretsu system. As a result, any future Congressional debate about the role of the financial sector in shaping U.S. competitiveness has to focus on the related issues of corporate governance and control. Should U.S. banks be permitted to own 5-10% of industrial firms which need long-term guarantees of ownership stability to complete investment projects? Since the U.S. tax system provides a fiscal incentive for firms to use debt rather than equity, is it not logical for industrial firms to pursue cross shareholding relationships with banks which would maximize their ability to use leverage? Is the fledging merchant bank movement on Wall Street (securities firms acquiring control of industrial companies through LBO's) the first step towards closer integration of the financial and commercial sectors in the United States? As the debates now occuring within Japan and Germany about their ownership systems will testify, there are no simple comprehensive answers to these questions. As with most public policy debates, the questions raised by the structure of a country's banking institutions and its system of corporate governance center on tradeoffs rather than absolute outcomes. How do we achieve the long-term investment horizons provided by the bank dominated form of capitalism without losing the flexibility and entrepeneurship often associated with the stock market form of capitalism? The answer may well be to let the two systems co-exist in the U.S. during the 1990's by relaxing the barriers separating commerce and banking while creating more fiscal incentives for firms to use equity rather than debt.

THE COST OF CAPITAL AND BANKING

Most academic discussions of American competitiveness usually conclude with a strong endorsement of new tax policies designed to bolster the national savings rate. According to conventional wisdom, a higher savings rate would lower America's cost of capital, boost the investment rate, and thus set the stage for a higher level of productivity growth. In the case of the financial service industry, a higher savings rate would permit banks to obtain equity capital at prices more favorable than prevailed during much of the 1980's.

The only problem with this argument is that in an age of global capital mobility it is unclear whether the relationship between national savings rates and cost of capital will continue to be as strong as it was in the past. Consider, for example, the current level of real bond yields around the world. In Japan, the nominal bond yield is 7.1% and the inflation rate is 2.5%. In the United States, the nominal bond yield is 8.4% and the inflation rate is 5%. As a result, Japan now has higher real long-term interest rates than the United States despite the fact that its savings rate is considerably higher.

How can this be? The answer is simple. Because of Japan's inflated real estate and equity prices, Japanese investors find foreign investments far more attractive than domestic alternatives. As a result, they have been exporting capital on a scale far in excess of the country's trade surplus, depressing the yen and pushing up interest rates. At some point, the upsurge in bond yields will self-correct by depressing asset prices and slowing capital outflows. But despite a 20% stock market decline this year, the yen remains well below the levels of one year ago while Japanese bond yields are holding at high levels in real terms.

The Tokyo stock market crash of 1990 does not mean that countries should cease to have pro-savings tax policies, but it does raise a number of interesting questions about how to design an optimal pro-investment tax system in an age of global financial integration. Can a nation retain a cost of capital advantage if its financial markets are fully integrated with the rest of the world? Are Japan's large capital outflows a one time response to the unique asset inflation which occurred during the late 1980's or are they a sign that Japan is losing its ability to subsidize investment through high domestic savings? Will Japanese firms be able to maintain their cross shareholding networks if their real borrowing costs rise sharply due to world financial market integration? Will the rise in Japanese borrowing costs resulting from capital outflows depress its domestic investment rate but raise the investment rate of other countries?

Because the movement towards global financial integration is so new, it will be some time before we have good answers to these questions. Clearly, capital mobility reduces some of the advantages of a high savings rate but there are still so many barriers to free movement of funds that national savings rates are not yet unimportant. Japan, moreover, has such unusual asset markets that it is always dangerous to overgeneralize on the basis of her experience. But the events of the past year do suggest three things about the relationship between savings and investment. First, we may now need co-ordinated global policies to boost savings, not just domestic policies. Second, if the U.S. does pursue a more pro-savings tax policy, we should not automatically assume all the benefits will be felt here. If some other region of the world is booming (say Eastern Europe), it is possible that U.S. capital would flow there and keep domestic interest rates high despite a rise in the domestic savings rate. Finally, it should now be obvious that it would be wrong for the U.S. to restrict foreign investment, especially from Japan. The large outflow of capital from

Japan is helping to correct America's savings problem and lowering our capital costs while increasing the cost of capital for Japanese industry.

POLICY CONCLUSIONS

The international competitive position of the U.S. banking and financial service sectors during the 1990's will be shaped by the interplay between several domestic and external factors.

On the domestic front, the competitive position of U.S. banking will be influenced by the outcome of several policy questions still to be resolved. Will the U.S. Congress eliminate Glass Steagal? How rapidly will America's banks accept nationwide branching? Will the federal government be able to develop an adequate system of banking supervision? Will the Congress and the administration take fiscal actions to raise the country's savings rate and lower its capital costs? Will Congress and the White House rethink the rules governing the relationship between banking and commerce in order to meet the unique competitive challenge posed by the Japanese and German forms of capitalism?

On the external front, the issues are much more complex. Can the U.S. use the GATT discussions to liberalize trade in financial services? How far should the U.S. push Japan to accelerate liberalization of its financial system in the current bilateral talks about financial regulation and trade liberalization? Will market liberalization in Japan retard the position of American banks or will it undermine the special cost of capital advantages hitherto enjoyed by Japan's banks? Should our criteria for success in negotiating with Japan be to obtain a variety of profitable niches for U.S. banks or to create a totally level playing field between domestic and foreign firms? If Japan refuses to accept America's liberalization proposals should the U.S. apply selective sanctions on Japanese firms or take more far-reaching actions to curb Japanese investment here? If the U.S. does retaliate, will it merely worsen its own long-term competitive position by reducing Japanese investment here and thus increasing America's own capital costs?

As a result of the complexity of the global challenge now facing America's financial service firms, any public policy designed to enhance U.S. competitiveness will have to be subtle and sensitive to the realities of the marketplace rather than ideological and legalistic. What would constitute a realistic trade strategy?

The U.S. should continue to advocate the principles of market liberalization, non-discrimination, and national treatment at GATT and other trade forums. With technology steadily eroding the barriers to trade in financial services, market forces, alone, should encourage a long-term convergence in many aspects of microeconomic behavior, including the operations of financial institutions. But because the economic traditions of the U.S., Japan, and continental Europe are so different, it would be unrealistic to think that there can be a rapid movement towards microeconomic convergence in all three marketplaces simultaneously. As a result, the U.S. will have to develop some second best strategies for improving its commercial position in Japan and continental Europe until market forces, alone, erode informal trade barriers. These second best strategies could include the following policy options.

First, the U.S. government should itemize the microeconomic divergences in foreign countries which often serve as a barrier to free trade in goods and services and make proposals for how they might be modified in order to improve market access. Since the mid-1980's, the U.S. Treasury has done an impressive job of focusing attention on Japanese microeconomic policies which restrict foreign access to that market. This process began with the yen-dollar talks of the mid-1980's and culminated in the Structural Impediments Initiative talks earlier this year. While there are limits on how far the U.S. can push microeconomic reform in other countries, the yen-dollar talks and the SII should be regarded as important conceptual break-throughs for correcting informal barriers to trade.

Secondly, when it is clear that microeconomic divergences will be a barrier to market access for several years, the U.S. should attempt to maximize America's commercial opportunities in foreign markets through political moral suasion. Under such a framework, the U.S. would accept that it will be difficult for American banks to penetrate the Keiritsu barriers to Japan's commercial lending market, but the U.S. could expect Japan's government to help provide American firms with alternative niches in pension fund management, stock broking, and corporate finance services. In fact, the U.S. has already developed a trade relationship in financial services with Japan which constitutes a de facto form of managed trade even though officials in both countries are reluctant to use that label. Japan has attempted to compensate U.S. banks for their low market share in traditional forms of lending by providing them with access to specialized niches which are not available to their domestic banks. In the early 1980's, these niches included foreign currency lending and access to uncollaterialized money market loans. More recently, the MOF has permitted foreign banks to obtain trust bank licenses even though domestic commercial banks cannot enter this business. In the latest readjustment of security industry commission rates, the MOF also was very careful not to alter commissions in the category of trades most often given to foreign brokerage firms.

Needless to say, there are major theoretical problems with the U.S. actively promoting a strategy of managed trade in financial services. Such policies will automatically be skewed in favor of existing large players or so-called "national champions", not new entrants. As a result, they would discriminate against small or second-tier U.S. firms which Tokyo did not perceive to have as much political clout as the larger firms. Providing American firms with access to hitherto closed or restricted market niches in Japan also will create an American constituency for protecting Japan's financial cartels rather than liberalizing them. In fact, some New York and London firms support Japan's tradition of fixed brokerage commissions because their tiny market shares in Tokyo already generate more income than their larger market shares at home. Although these U.S. firms often recognize that Tokyo's domestic financial cartels provide Japanese firms with the high profits necessary to push into their home marketplace, they nevertheless appreciate the stability of their profit margins in Tokyo compared to other markets. But whatever the long-term dangers posed by Japan's system of managed trade in financial services, the fact is it has provided American firms with more profitable niches in that marketplace than would have otherwise occurred. The great challenge now facing American policy makers will be to develop an overall framework for trade relations which maximizes the benefits of managed trade for American firms in the short-term without impeding progress towards more open markets for everyone in the long-term. As a result, the use of managed trade agreements should not occur through Congressional law or formal treaties. There should be informal but well understood agreements that Japan or continental Europe are providing U.S. firms with particular "trading offsets" in various product marketplaces in order to compensate for the fact that U.S. firms have restricted access in many other important markets. The U.S. Treasury and the U.S. Trade Representative could then update these "trade offset agreements" every few years in order to reflect the changing realities of the marketplace. With luck, they would be totally unnecessary by the end of the 1990's.

Thirdly, in pursuing "offset trade arrangements" in financial services, the U.S. should recognize the importance of America's continuing need for foreign savings to finance its large budget deficits and compensate for its low domestic savings rate. As noted previously, the large outflow of capital from Japan now threatens to undermine one of Japan's major economic advantages in the modern era -- a high savings rate and low cost of capital. It would be silly for the U.S. to pursue a managed trade policy in financial services which kept more capital in Japan and pushed up America's own interest rates. We have to encourage microeconomic reform and pursue greater market access in Japan or Europe without creating worse macroeconomic problems in the U.S. itself. Obviously, other countries could attempt to take advantage of our dependence upon their savings by refusing to liberalize their markets, but as the recent Japanese efforts to comply with both SII and Super 301 requirements will testify, the U.S. can seek foreign market share through selective sanctions and political moral suasion, not far-reaching restrictions on foreign investment here.

Fourthly, in monitoring U.S. financial service trade policy, the U.S. Congress should give Japan some credit for having purposefully developed market niches for American firms and pay more attention to the relatively weak position of U.S. financial service firms on the continent of Europe. Because of German unification, the movement towards European integration, and other political changes now occurring in Eastern Europe, there is no doubt that the European marketplace for goods and services will be one of the most dynamic of the 1990's. The U.S. already enjoys a healthy position in most of Europe's goods market both through direct investment there and exports from American based plants. But the U.S. presence in the European financial service sector is very modest because of both formal trade restrictions and informal microeconomic barriers. As a result, there should now be greater official emphasis on improving American access to the European financial marketplace. In the short-term, this should occur through GATT, but there is also a good case for the U.S. to conduct an SII style review of European microeconomic policies, which inhibit American access to that marketplace, not just official rules and EC directives. Among the issues which might be examined are the effects of Europe's corporate cross shareholding systems on banking relationships, and the insider trading or anti-trust aspects of national savings being concentrated in a few financial intermediaries. Because Europe's financial institutions are often far less compartmentalized than Japan's, it may be more difficult for U.S. firms to obtain specialized niches, such as pension fund or trust banking managment, to serve as "offsets" to America's low market share in commercial banking. But with the global financial service industry now in a state of technological and regulatory flux, there should still be far more opportunities for America to exploit in the Europe of the 1990's than in the past.

Finally, the U.S. must pursue a mixture of microeconomic and macroeconomic policies at home conducive to the growth of strong and internationally competitive financial institutions. The U.S. has to develop a new framework for universal banking which will encourage more effective co-operation between American commerce and finance without losing the entrepreneurial flexibility that came from America's traditional system of stock market based corporate control. There has to be a significant upgrading in the quality of U.S. banking supervision, including competitive salaries for regulatory agency personnel and effective restrictions on political interference in the supervision process. The U.S. has to pursue macroeconomic policies which bolster national savings, reduce domestic capital costs, and create an environment for sustained non-inflationary economic growth. In many ways, the domestic agenda for international financial competitiveness poses more formidable challenges than the international components of the agenda, but U.S. financial institutions cannot be effective players on the world stage if their domestic environment is characterized by high capital costs, poor credit quality, and erratic standards of regulatory supervision.

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*The opinoins expressed in this paper belong to the author and are based on several years of research in the field of international economics and banking. They are not a reflection of corporate policy at Kemper Financial Services or its affiliates.

The **Chairman**. Well, thank you very much for another excellent presentation with a lot of provocative thoughts that I think will be helpful to us.

Let me ask two or three questions at the outset.

I would like to ask each of you, and you've dealt partially with this in your comments, can the United States in this global economy in which financial services are becoming more internationalized each day, and for that matter can any major nation, be an anomaly in that system? In other words, can you in fact have a national system that is fundamentally out of sync and different with the rest of the world in a globalized system and at least in theory still be able to prosper and to function effectively?

Or do we have to conclude that in a globalized system, whether people like it or not, regardless of which nation we're talking about, there has to be some effort to gear into the international system and that there are real limits to a nation's ability to be anomaly even if you would prefer that course of action?

Mr. Cooke.

Mr. **Cooke**. Well, Mr. Chairman, that's very much I think the thrust of my concluding comment, that you cannot be an anomaly, and indeed I think this is very important if the U.S. economy in the years ahead is to play its full part in the global economy. I think it's very important the intermediation of the financial services sector should play its full part in that global economic process, and the more hiccups, and the more inconsistencies, the more difficulties there are for foreign authorities to open up markets because they are hesitant or doubtful about the inconsistencies which exist between their own marketplace and the U.S. scheme of things I think the more they will all be drags on the U.S. playing their full part in international financial affairs. I do feel that quite strongly.

The **Chairman**. Mr. Chisholm.

Mr. **Chisholm**. I would agree that no one can be anomalous either, and I think there are several realities that have come to light over the last 10 years that would bear that out.

First of all, at least at the corporate end of financial services it's basically a business done by electronics. This explosion in global technology and global support electronics has fundamentally opened up world access to any player from any country who has got an advantage, if you will.

So I think the key to seeing that U.S. banks are competitive is to allow as much harmony in terms of regulation internationally as possible, but that won't necessarily be enough. I do believe that the North American banks are disadvantaged in terms of cost of capital for the reasons in part that Mr. Hale expressed, but also because of some very significant macroeconomic differences between North America and the rest of the world in terms of fiscal management and the like.

Any of these disadvantages because of the pace of information sharing and the application of this new global technology and the delivery of global financial systems can be arbitraged to the advantage of whomever has that particular position at a point in time. The more harmony I think the better, or we'll find increasing an inability to compete.

The **Chairman**. Mr. Hale.

Mr. HALE. I think many of the trade tensions we now face, and not just in financial services, but in all areas reflect the fact that we have very differential stages of integration for the financial marketplace, the goods marketplace and the political marketplace.

Because of technology, the financial marketplace is now in the 21st century, the goods marketplace reflects the world around us, and the political marketplace for regulation and tax policy reflects the 18th century nation state.

This kind of divergence is very hard to sustain when you have a common global marketplace, and I would say this applies not just to financial services, but to tax policy, to environmental regulations and to a whole range of global policy issues we've hitherto thought of only in narrow compartmentalized national terms.

Europe has gone the furthest obviously in narrowing these differences, but I think all the industrial nations will have to pursue a kind of microeconomic convergence over the next decade in order to deal with these issues of competitiveness and of trade management.

The CHAIRMAN. I might just say as an aside that I think that adjustment process in many ways is a very difficult one for the United States intellectually and psychologically and it's ironic because on the one hand we've had a long history of being pragmatic and able to adapt and to move in certain areas I think at a high rate of speed.

On the other hand, I think in the aftermath of World War II and the time since then, there has been a tendency to still have an impulse or reflex as a Nation to feel that we can kind of go our own way and do it our way and sort of key off our history that has been comfortable to us and satisfying to us without having to necessarily bend ourselves into a new form to accommodate a global system.

I think it's a very hard intellectual adjustment to make. We are about 4 percent of the world's population, but I don't think we have thought of ourselves in that way. As a result the need to make rapid and substantial changes to gear into external realities, is something that I think doesn't come automatically here in this country, especially on complex policy and structural matters. It leads in one dimension right to the question of the number of banks we have in the United States.

In one way or another I think you've all touched on the fact that our history has evolved in such a way that we have a very large number of banks of various sizes across the country and different kinds of banks. As a result, we have a very diverse and very large universe. It's shrinking, but nevertheless it's still several orders of magnitude above what we see in most other places.

Are you all of the view that one of the adjustments that will have to be made here is that there will have to be a substantial reduction in the number of banking institutions as we go forward, whether we like it or not?

Mr. Cooke.

Mr. COOKE. I think that these questions are all very complex, and I think it is always very foolish to ignore the history of a particular country's evolution in terms of its financial system. That's not all bad. Just because it doesn't happen to agree with what everybody else is doing in the rest of the world doesn't mean to say that the

United States has got it wrong for the United States necessarily. But there are a number of comments that have been made that suggest that the U.S. hasn't got it all right either.

It seems to me in terms of this process of coordination of the framework of financial supervision around the world that it has to be a very delicate and also a very political blend. It also has to be a technical blend between the realities of what can be achieved in different countries and the need to balance the elements where some degree of harmony should be found and other elements where such harmony really isn't critical to maintaining a proper relationship between major economies.

I think that the scale of the U.S. banking system, in terms of number of institutions, is provoking problems for the U.S. banks in terms of their international profile. In many ways I think there is evidence that a lot of U.S. banks are extremely competitive domestically with other domestic institutions and are not suffering particularly from the system. Also, the degree of aggregation of banking units that have taken place in this country over recent years, notably through the holding company structures, is probably a good deal larger than the apparent reduction in the number of banks would make it appear to be.

But I think that further rationalization is probably inevitable in the interests of competition. But provided there are enough large units of those institutions which are operating in the international marketplace and provided they are structured and organized and run in a way which can enable them to compete on fairly equal terms with major institutions in other countries, I don't think that necessarily you've got to do away totally with smaller domestically oriented institutions where they are serving good local purposes. But I would certainly see the trend towards a continuing reduction in the overall number of banks on rather simplistic economic grounds.

The **Chairman**. Mr. Chisholm.

Mr. **Chisholm**. I think in part to answer the question I would lean a little into the Canadian experience. Our particular bank has 1,200 branches nationwide. The big six banks in Canada have 7,800 locations. So if you look today at the U.S. banking scene with 14,000 independent banks, if that implies 14,000 banking locations to serve the consuming public, that probably continues to be highly desirable.

On the other hand, again comparing the retail banking systems of the two countries, first of all, the Canadian consumer is far, far better served by its banking network in Canada than it is in the United States in terms of matters of float, service charges, the quality of product, the response time and I think frankly the safety of the deposits, whether it's under a deposit insurance scheme or whether it's just looking to the scale of diversification of the big six banks.

I would offer that there probably will be material rationalization of the numbers of individual legal entities that represent viable banking operations in the United States. I think caution has to be taken to make sure that there isn't a communion of too many of the big banks with each other because again you want a diversification of the numbers and scale of financial institutions serving both domestic and international needs. But over time I think a system that results from a good deal of rationalization and consolidation will be welcome.

The CHAIRMAN. Mr. Hale.

Mr. HALE. I would like to make two points.

First, I would like to amend Mr. Chisholm's comments. Canada had a brief experiment in the last decade with regional banking in British Columbia and Alberta. For the same reason that our banks in Texas often failed here in the last 5 years, low commodity prices and falling real estate prices, those banks failed and had to be absorbed into large institutions.

So despite its long history of a very concentrated system, there was a desire on the part of some Canadians in the 1970's to have regional autonomy, a head office in Vancouver and not just in Toronto.

The second point I would make is in looking at our problem in particular, it's important to distinguish between the number of banks and the rules guiding the banks. We had 14,000 banks throughout the entire post-war period, but there were no major problems because those banks operated as a kind of Government-sponsored cartel. We had ground rules for deposits and yields, we had ground rules for what banks could pay for their money and also a lot more ground rules in terms of what they could invest in.

Really the problem is to have adequate supervision for all these banks in a period of deregulation and in a period of much more open and free competition, clearly in the 1980's we did not raise enough money or spend enough money to do that job adequately.

Therefore, if we had proper taxation and proper regulation funded by taxation, we might have a cost structure from regulation that would in turn encourage more rationalization. All problems in economics center on price, and the problem here in the 1980's was we didn't spend enough money and therefore we underpriced the regulatory aspect of banking and many problems flowed from that.

I like the diversity of our system. I personally like the fact that I have lots of choices. I would hate to lose that, but we have to price it properly, and we did not in the 1980's.

The CHAIRMAN. As an aside, and it's relevant to other debates that are going on these days, we have the Gramm-Rudman-Hollings automatic cutting mechanism that comes into play at different times. At a couple of key points in the 1980's there was a very spirited debate right here in this room as to whether the Gramm-Rudman-Hollings automatic cuts should also take a slice out of the regulatory force overseeing banks and savings and loans at a period of very major deregulation, as you say. After a spirited debate in this room we actually had a vote on that subject, and there was a one vote difference. I mean that's how closely divided the opinion was as to whether the automatic cutting mechanism ought to slice off more regulators at a time when the regulatory requirements were actually spiraling to an enormous new size.

Then we went to the Senate floor on that very same issue, and because of the rules that apply we lost that vote on the floor. We needed to have a 60 vote margin because of a parliamentary point of order that could be applied under the budget rules. So in fact, the Senate in the first go-round went on record as actually using the Gramm-Rudman mechanism to cut the banking savings and loan regulatory force. We ended up winning that fight, finally, in the Senate-House Conference, but that's how directly relevant that particular issue was in terms of what actually went on, and it does raise very important questions.

Let me ask you with respect to deposit insurance. As you know, we now have this system where we guarantee in federally insured institutions up to $100,000, but there are ways for people to multiply that any number of times by going to different institutions.

I would appreciate any one-for-one comparisons of the kind of deposit insurance scheme that you would like to make. But also how would you tend to react to the idea of deposit insurance scheme in the United States, and there are a lot of ways to revise this, that would give every individual the maximum of $100,000 of deposit insurance wherever they put the money, whether they put it all in one institution or they broke it in pieces and put it in different institutions; a federally protected deposit insurance sytems in which no individual could have more than $100,000 covered?

What would be your reaction to that kind of a change?

Mr. Cooke.

Mr. Cooke. I think one of the troubles with talking about individual countries' deposit insurance schemes is that they all derive from a national psychology history and experience, which is different. So everybody is at a different starting point at the particular moment, and this is one of the reasons why, in the context of the European Community, I think it was one of the main reasons why it was decided that there would be no effort to standardize a deposit protection scheme throughout the community.

There was, however, a strong feeling that some kind of deposit protection for the small depositor at least should be a part of everybody's national system without specifying its details. The more you look at the deposit insurance schemes in the European countries, the more differences of detail there are in them which derive from different perceptions of what purpose they should serve.

The European schemes are all significantly smaller in scale in their protection of the depositor. The particular suggestion you make that there should be an overall systemic limit to the coverage provided to any particular depositor is one possible approach.

I think there is an enormous problem, and I don't know quite how you would administer it, and how you would track down the information about the different institutions in which everybody had deposits. Perhaps you wouldn't need to, except in the event of failure.

One of the benefits of course of a low ceiling for deposit protection is that it does encourage the depositor to shop around a little bit and not to put all his eggs in one basket, and the more that is done, the more you are likely to induce a active participation by the depositor in the process of assessing the quality of individual institutions and thereby inducing a sense of market discipline in the depositor which helps to do away with the need for deposit protection at all.

The Chairman. Well, let me just stop you there and say in that respect that today's culture is moving at a pretty fast rate. I mean the tremendous rise of the fast food business and people doing the drivethroughs to get a hamburger in a split second is indicative of the time pressures that are on people. In most families today you've got two people working. Furthermore, given the complexity of trying to understand whether or not a bank or an insured institution is well run, in light of all of the other requirements that are imposed on every person each day I just don't know that we can really expect the buyer or the saver to beware and somehow be savvy enough to discern whether a bank is safe or unsafe.

I'm not sure it's realistic to expect people to do that. I think that is one of the reasons we have Government, and we have regulatory schemes, and we have the proper private market practices, and so forth so that we have some measure of what's going on, particularly if we're going to have any element of deposit insurance where the taxpayer is on the hook and where the Government or the regulatory process and industry itself have some very compelling responsibility to make sure that they are not running way over the margins and setting up system for a major fall.

So I just don't know. I'm thinking of the citizens of my State and around the country that are doing their best to try to work and function each day. Should they be expected to somehow have the expertise to figure out that bank A is a better place to save than bank B, all other things being equal, or that savings and loan "X" is better off than a mutual savings bank down the street?

I just don't know that it's realistic to ask people to carry out that function or whether they can properly do so for themselves.

Mr. COOKE. Well, I understand that, Mr. Chairman, and indeed I think that is a prevalent view in a number of countries, and I think probably it's quite a strongly held view in my own country, although there is some limit to the degree of protection which is provided.

In some European countries I think you will still find, despite the introduction of some limited schemes, a fairly strong philosophical sense that the consumer should take more care of himself than the State should, and that's why I said there are national environments within which these debates are pursued which are very important and are very different.

I think it also of course has to be linked to the national policies and traditions on lender of last resort responsibilities of the central bank vis-a-vis the banking system to the extent that this provides some kind of underpinning of the safety of depositors' monies, and there again you have to look at the question of deposit insurance in the light of those arrangements and the way in which they have traditionally been undertaken.

In Australia, for example, I think I'm right in saying that the Government has more or less said in so many words that all chartered banks will be protected by the Government. In that sort of an environment there is no need for depositor protection, and there will be variations of that all around the world.

The CHAIRMAN. You've seen now two systems side-by-side. So that helps you to some extent in making that kind of an assessment.

Mr. CHISHOLM. Unfortunately, there isn't a more favorable contrast to draw in this particular respect between Canada and the United States. Canada's system is almost identical to the one here.

The limit in Canada is $60,000 versus $100,000 in the United States.

The CHAIRMAN. When was that established? When would the $60,000 figure have been put in place, do you know?

Mr. CHISHOLM. I can't tell you off the top of my head.

The CHAIRMAN. Has it been that way for several years?

Mr. CHISHOLM. Yes, it has been.

Mr. Hale referred a few minutes ago to two Canadian bank failures, and he is correct, the Northlands Bank and the Canadian Commercial Bank were both regional in terms of their deposit taking and their lending and failed several years back. The deposit insurance scheme worked for everybody who had the insured deposits, but everybody who had uninsured deposits was also compensated by the Government, with the exception of the six banks who also put up part of the safety underpinning to actually absorb those particular institutions.

That doesn't foster the kind of market discipline in a sense that I think Mr. Cooke was referring to. What that means basically is all banks, regardless of their financial management or the management of their internal risk policies and so on is not advantaged. In other words, there is nothing to encourage more prudent management of a financial institution's affairs.

We tend to favor several schemes now that are being developed in Canada that do put more market discipline in, either a claims adjusted premium system for banks rather than a percentage of total deposits, or the idea that the insurance fund will be built in part based on subordinated debt issued by the banks that are having to self-insure, and the way that subordinated debt trades in the market will be an indication of how the market perceives the safety and soundness of those institutions, or because of our rather unique regulatory framework and the fact that there are only six major institutions in play using some sort of a quality assessment of how they are actually managed internally and have that as the criteria for assessing insurance premiums for the system.

Overall I'm sympathetic with the fact that the consumer can't maybe take the time to judge one financial institution to the next, which one is more sound than the other, but there is certainly an abundance of publicly available information now on a moment's notice if they choose to look from any of the major rating agencies that would I think be an excellent guidepost for them.

The CHAIRMAN. Just before going to Mr. Hale, can a citizen in Canada get the $60,000 worth of insurance coverage at 10 different banks at the same time?

Mr. CHISHOLM. Yes, he can.

The CHAIRMAN. Mr. Hale.

Mr. HALE. I think this is a very complex problem, and an economist would always say we should try and link the market to the price and so on, and therefore if you had restraints on deposit insurance and allowed banks to fail, you would get consumer discipline, and the consumer has not had any discipline on him since the Great Depression of the 1930's because of the creation of deposit insurance.

But as you indicated, the political reality is most people regard their bank as a kind of utility. They expect a guaranteed supply every day of safe water and of clean air and of other amenities, and I would say that banking falls on that list of amenities. Therefore it's going to be impossible for the public sector to just drop out of the picture or to let the market clear in a way that would damage large numbers of consumers.

So I'm afraid that while you could attempt to impose more market discipline, the reality would be you would still have to have a good system of supervision backing it up because at the end of the day you could not let a major institution fail without creating all kinds of other problems that would require the Fed to play a lender of last resort or for even other countries perhaps to help us out if it was a big enough institution.

So I'm afraid we're stuck with the need to address the issue in this country of supervision.

The CHAIRMAN. What do you think of the idea of a maximum of $100,000 being insured for a given individual no matter how they parcel it out to other institutions?

Mr. HALE. I think by itself it would have a benign impact in terms of making consumers more disciplined and making a greater effort to monitor risk. There would be a greater tendency now for magazines and newspapers to publish credit ratings at banks and for the kinds of things that we actually had in the 19th century. We had lots of information available about bank quality because during that period banks could fail on their notes and not just on their savings accounts and so on.

But it would require a long period of transition to get ready for this. You could not do it very quickly. I would say at least 5 years would be needed to get people acclimated and to allow money to move around in a benign way that wouldn't be disruptive and cause great problems.

But even with that $100,000 limit, I could still imagine circumstances in which the Government would have to play a lender of last resort role to maintain the overall stability of the system, unless we had along the way adequate supervision and adequate monitoring of the risk taking functions of the major financial organizations.

The CHAIRMAN. I don't know off the top of my head what the statistics are as to how many individual savers in the United States there would be that have something less than $100,000 in total invested in federally insured institutions and how many individual savers would have savings deposited above $100,000. I would guess it's a very big number below $100,000 and quite a small number above $100,000.

It seems to me, in effect, that if somebody wants the absolute security a Government insurance guarantee gives, you have another savings option available to anybody in this country even today, which is to buy a Government debt instrument. We sell them in denominations from 30 days on out. So, if somebody wants absolute Government protection, they don't have to take their savings to a federally insured savings institution once it's above a certain threshold. Instead they can get hooked into a system where they actually buy a Treasury instrument of some length. In that fashion, they pick up their risk-free Government backing. So I think there is another way for those savings to be rerouted if in fact that is the critical factor in a saver's mind.

But the question of whether or not we ought to continue to allow multiples of $100,000 in unlimited amounts, especially when you've such a vast number of banks here, leads over into the broker deposit issue.

Let me ask you this. When we had Mr. Corrigan here on May 3, he said this, and I quote him. He said "The worst single abuse of America's deposit insurance system has been the abuse of broker deposit arrangements." Now that's obviously his view.

I'm wondering, are broker deposits used in Canada, England or Japan respectively? I'm also wondering whether any one of you tend to agree with Mr Corrigan's observations and, if so, why you would or why you might dissent.

Let's go back the other way this time. Mr. Hale, let's start with you.

Mr. HALE. To my knowledge, this is a uniquely American phenomena, but I don't have the factual data to be able to stand behind that. My impression of working with Japanese bankers and Australian bankers and European bankers is this is very much an American institution and it reflects once again the proliferation of new products in the 1980's and the very intense competition that came from our new rules.

The CHAIRMAN. Mr. Chisholm.

Mr. CHISHOLM. In Canada there are securities dealers who are in effect brokers who are more sophisticated than Mr. Corrigan was talking about who can broker individual bank paper and they can broker individual pieces of commercial paper and banker's acceptances in private sector names.

They do not have, to my knowledge, any responsibility to attest to the creditworthiness of that paper, but there are again public ratings against the paper and what-have-you.

The brokerage system that Mr. Corrigan was referring to started in the middle 1970's with corporate depositors of funds, and there have been instances over-and-over again where the broker was assumed to be making some added station to the quality of the credit involved, and in the end there were several failures where the corporate had no recourse at all to the broker. It's not a practice that I think should be encouraged.

The CHAIRMAN. Mr. Cooke.

Mr. COOKE. I'm not sure I know well enough exactly what Mr. Corrigan was referring to to be able to offer a useful comment on this point.

The CHAIRMAN. All right, very good. We've had this situation here in the United States where these broker deposits in large pools of savings are collected and sort of put on a money conveyor belt and sent around the country to institutions offering the highest interest rates. They are broken into pieces to keep the amounts in any given institution below the insurance limits. However, you can take and shoot an awful lot of money around the country, and we saw a lot of that in the savings and loan situation where with interest rate deregulation multiplied by state chartered thrifts in some States who had a wide-open set of operating powers, and all of the sudden you got vast amounts of money being collected in the money centered areas and being conveyed out to those institutions in those States that were offering the federally insured above market interest rates. An awful lot of money in a sense moved out in that fashion and all the time putting the taxpayer on the hook with, I think, a failure of a clear recognition of the size of the liability that was building up if the system were to suffer a failure, and that happened.

It turned out that the two States that have contributed the overwhelming share of the losses are the States of Texas and California where they have State chartered thrifts with this very broad operating charter. For example, in 1988, 70 percent of all the losses in the savings and loans system came from State charted institutions in just those two States, and behind that was this conveyor belt of broker deposits that had built-up over time using the Federal deposit guarantees, the competitive interest rate attraction, and the fact that by taking and bundling this money and shipping it around the country, it was a system that almost was designed to fail at some point.

The fact that maybe all the connecting links were sufficiently understood is a commentary on why the system broke down, but in retrospect it's obvious that was a very major cause of the problem.

Mr. Cooke. I think, Mr. Chairman, I would agree with what Mr. Hale said. I don't think this is a particular feature of the European scene. I don't think something of this kind really exists there.

It does raise in my mind though a related question, and that is the question of the degree to which you should be seeking in a deposit protection scheme to protect the interests of the small man, if you like, or of the individual and the extent to which you should be seeking to protect the interests of the corporate institution and/or a financially sophisticated institution, for example, a bank.

In the British scheme the deposits made by one bank with another bank are not covered by the deposit protection arrangements. So that if a bank goes down, all the interbank deposits with that bank are not protected. It's only the deposits of individuals.

When we were looking and constructing the scheme originally——

The Chairman. It's an interesting idea.

Mr. Cooke. In 1979 when we were looking at our scheme and first putting it in place, it was put in place perhaps as much to allow the authorities the freedom to let banks fail as much as to protect the interests of the small depositor. The more you protect the interests of the small depositor, the more you may feel free as the authorities to allow institutions to fail because the consumer protection interests will have been looked after.

If you don't have a deposit protection scheme, then to some extent you're more inhibited from allowing an institution to fail. That was the slightly perverse way of thinking which led us to introduce the scheme, but we did not introduce it for institutions which were themselves deposit takers. We discussed at some length in the United Kingdom whether we should restrict it to individuals, and the definitional problems of that were absolutely too great to be handled in relation to partnerships and one-man businesses and the rest of it.

So corporations were covered, but I think there is a question as to whether deposit protection schemes should in some way be tailored to limit the protection given to people who ought to know better and can be expected to know better.

The CHAIRMAN. Gentlemen, I have some other questions that I want to raise with you, and I'm just going to raise one more now and perhaps ask you to respond to some for the record, and some of my colleagues also who could not be here have hoped that you will respond to some questions from them for the record.

I must go to the floor and play a part in an amendment that is now up on the housing bill myself very shortly.

I would like to finish up this morning by inquiring of each of you, and if you can give me kind of a brief answer on this, what actions you think we can take. I mean having said all that has been said today, what actions can we take to increase the competitiveness of our depository institutions and at the same time protect the deposit insurance system from some significant expansion and the risks to that system?

I'm wondering as you think about it, what do you think is the one, two or three most important actions at this time that you think we ought to be taking that on the one hand could improve our competitiveness and on the other hand not increase the risk to the deposit insurance fund?

Who would like to go first?

Mr. COOKE. Well, I do think limiting the coverage, which I just referred to, is one possible route if you can find definitions which enable you to distinguish between different institutions not to provide a bailout for everybody.

The other thing of course, which a number of European countries I should point out do do, is that they do not actually provide a fund such as exists under the FDIC for providing deposit or protection in the event of a bank failure. It is a mutual scheme which is provided within the industry itself. So the funds, as and when they are needed to bail out depositors, they don't come from the Government or from the budget. They come from the contributions collectively of the institutions who are the club of deposit taking institutions. That seems to work pretty well, and it has worked pretty well in Germany for a number of years, and it seems to be generally accepted as one which will work.

One of the difficulties of it——

The CHAIRMAN. I would think that would cause the major players to keep a close eye on one another because one guy could end up taking everybody else down.

Mr. COOKE. Well, that again induces a degree of market discipline to the process, which is perhaps advantageous. What it also does is it presents a little bit of a problem because the large players will say why should we who are undoubted undertake to put up money for a scheme which will protect all these fly-by-night little institutions who are paying up for deposits at quite unreasonable levels, offering the public a far higher rate of interest on their deposits than they should do, and once they are within the net they are automatically covered by our protection. That objection was one of the reasons why that particular approach was rejected in my country 10 years ago.

But, nevertheless, that is another aspect that might be worth further consideration.

The **Chairman**. Mr. Chisholm.

Mr. **Chisholm**. There isn't a lot I would add to Mr. Cooke's remarks other than to repeat my one thought about the need to open up interstate banking as quickly as possible because we believe that a very diversified deposit source that then lends itself very well to a very diversified outlay of assets to offset the deposits taken in is one of the fundamentals of a very sound banking system. As you move down that road with market discipline along the lines of deposit insurance the way Mr. Cooke has outlined I think are the other two imperatives, but one without the other to me is not effective.

The **Chairman**. Mr. Hale.

Mr. **Hale**. I would echo some of those comments, and just magnify one or two by again stressing supervision and the importance of having adequate funding for it and, if necessary, even having a separate funding source for bank supervision by having industry specific taxes or user fees that are not going to be subject to Gramm-Rudman sequestration or other kinds of political interference. They would stand by themselves and be seen as the price of having an adequate and safe banking system and therefore not be vulnerable to all kinds of political shocks or economic shocks.

I really think a lot of our problems in the 1980's comes from the deterioration of the quality of our public sector, which the other countries that we're competing with, especially Western Europe and Japan, benefited from the consistency, coherence and overall competence of the people in their public sector. Competent civil servants are able to use moral suasion to intervene discretely and to prevent behavior which often leads to major problems here because we don't have faith in our institutions and don't have a tradition of cooperation. There is no way around that. We've got to spend the money and have guaranteed funding for adequate supervision.

The **Chairman**. You know, it's interesting. I was talking with Senator Bentsen the other day, who of course is the Chairman of the Finance Committee, and he gave me these numbers, which I'm in the process of checking and adding to. He indicated that in the State of Texas back in 1981 that there were 54 regulators, and I'm not sure whether those were just S&L regulators or S&L and bank regulators, in the State during the supervisory tasks and so forth.

And of course then we went through this explosion of deregulatory activity greatly expanded by the expansion of state chartered institutions who were given even broader operating authority with a much higher risk profile, and he indicated that 4 years later by 1985 after this burst of deregulatory activity and huge expansion, the number of regulators had fallen from 54 in the State of Texas to 12. So that we were seeing both things happening at once. It was a wide open game being created in terms of financial service activity and the risk profile going with it, and a very material subtraction from the regulatory force.

I think you find just in the savings and loan debacle, which is one that we're all more and more familiar with at this time, that 70 percent of the losses in 1988 occurred in just two States, that is

70 percent of the national losses occurred in just two States and come from State chartered institutions in those States operating under this regime.

I mean I don't think the public has any sense of that at the moment because it's just too complex an issue to sort out, but it really is a breath-taking fact when you think about it, and especially when we see that kind of data with respect to the elimination of the regulatory force, if you will. I mean to go from 54 to 12, you know, I can't imagine. The 12 must have been highly neurotic trying to keep track of what was going on, but how could anyone do it. I mean obviously it was not possible to do it, and it sort of brought us to today's situation.

Gentlemen, thank you very much for your help today. I will be submitting some questions to you for the record from colleagues and some from myself.

The **Chairman**. I must go now and vote. We have a vote on the Senate floor, but we thank you very much for your constructive contribution.

The committee stands in recess.

[The committee recessed at 11:40 a.m., subject to the call of the Chair.]

[Response to written questions of Senator Riegle follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

David Hale

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Q.1. You state on page 11 of your testimony that:

"While the quality of financial regulation has not played a major role in discussions of international financial competitiveness, there should be no doubt that the inferior quality of America's system of financial supervision has damaged the country's bank competitiveness."

That is a very important observation. Could you please briefly explain why you think that is true?

1. According to numerous press reports, there was a deterioration in real funding for the federal government's regulatory agencies during the 1980's. This erosion in funding caused bank examiner salaries to become uncompetitive with private sector alternatives and encouraged experienced staff to leave the government. As a result, we did not have effective regulatory agencies at a time when deregulation increased the need for careful supervision. This factor has damaged U.S. international competitiveness in several ways. First, the lack of proper supervision encouraged reckless forms of competition in both lending and deposit gathering. This behavior adversely affected the profits of all U.S. banks, not just the ones pursuing the most risky loans. Secondly, because of the loan quality problems of U.S. banks, many of our financial institutions have both low equity valuations and poor credit ratings. Hence, it is expensive for them to raise new capital in any form. Thirdly, cleaning up the mess left by the regulatory failures of the 1980's will require tax increases, including higher deposit insurance fees. These hikes in taxation and deposit insurance costs will adversely affect the profitability of U.S. banks, especially compared to countries where deposit insurance is inexpensive. Finally, it is important to remember that other countries assign a much higher priority to recruiting the best possible people to their government institutions, including financial regulatory agencies. As a result, their system of supervision has been more effective at discouraging the imprudent and reckless forms of competition which characterized the U.S. financial sector in the 1980's and which will require large U.S. tax increases in the 1990's.

Q.2. During our June 13 hearing, Mr. Toru Kusukawa, the Deputy President of the Fuji Bank, told us the international competitiveness of banks is largely influenced by the overall economic performance of its home country.

Do you agree with his assessment and if so how much can we increase the competitiveness of American financial institutions through product or geographic expansion or better supervision if we do not deal with the larger macro-economic factors hindering the overall performance of our economy?

2. Mr. Kusukawa is correct to argue that the overall economic performance of a country has a major impact on the performance of the banks. But as America's experience during the 1980's will testify, macroeconomic policy is not the sole factor determining bank performance. Other aspects of policy, such as the quality of financial supervision and the microeconomic structure of the financial service sector, can play an important role. In the 1980's, the U.S. enjoyed the longest peacetime expansion of the post-war period. Yet, during this same period, we had a record number of failures in both the banking and the thrift industry. These failures resulted from a variety of factors, including geographic constraints on bank operations, wide divergences in America's regional economic performance, and the supervision inadequacies referred to above. As a result, it would be wrong to conclude that macroeconomic factors, alone, can shape America's international financial competitiveness. Although such factors are critically important, micoreconomic policy and institutional factors, such as quality of government supervision and interstate banking limits, also play an important role.

Q.3. You note on page 2 of your testimony that Japan now has the ten largest banks in the world, but note that in 1988 none of Japan's banks ranked among the world's ten most profitable on the basis of assets returns. You state:

> "This suggests that Japanese banks have either been winning market share at the expense of profit margins, or that they have been less successful than other institutions in developing fee oriented business lines."

Some commentators have suggested that it would only benefit American consumers at the expense of Japanese savers if Japanese banks expanded market share here at the expense of profit margins. Do you agree with that, or do you see a long term benefit to Japan through such a strategy by its banks?

3. The question is a complex one. There is no doubt that U.S. consumers benefit in the short-term from Japanese firms accepting low profit margins to win market share here. But it is far from clear that they will benefit in the long-term. First, if Japanese firms win a dominant market share, they could, in theory charge higher prices later on. Secondly, American financial institutions might respond to Japanese price cutting by reducing their own lending quality standards in order to obtain more profits from potentially high risk customers. Under such circumstances, the U.S. consumers could be compelled to pay higher taxes in order to finance bank bail-outs. Finally, one must ask "strategic questions" about the role of the domestic banking sector in the economy and whether there would be so-called negative "externalties" from an erosion in Americas's banking position. In a financial emergency, would the Fed get more co-operation from a domestic bank than a foreign bank? Because of the role played by banks in monitoring companies and gathering information, is it prudent to let foreign banks play a dominant role in financing our high technology industry? As my testimony indicated, I think foreign banks can help to boost U.S. competitiveness by reducing our domestic capital costs, but we must still set parameters for foreign market share because of the need to maintain a viable domestic banking sector and to guard against adverse externalities resulting from the unusual nature of the relationship between commerce and banking in Japan

Q.4. In his prepared testimony before the Banking Committee on June 20, 1990, Mr. David Hale, the Chief Economist for Kemper Financial Services, states that:

> "Japanese banks typically belong to larger industrial groups (*keiretsu*), in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."

Some observers claim the *keiretsu* structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

4. As my testimony indicated, there is no doubt that the Japanese Keiretsu system has helped Japanese banks to raise an abundant amount of low cost equity capital and thus to accelerate their international expansion. The interesting question facing Japanese banks today is whether it will be possible to sustain this system in the face of financial liberalization, rising real interest rates, and the new freedom of Japanese investors to export capital. Because of the recent Tokyo stock market crash, it is now difficult for Japanese banks to sell equity and some of the banks may be forced to issue a new form of bond offering 7-8% yields instead of the low coupon bonds incorporating equity warrants and equity convertibility options which were their major source of finance in 1987-89. If this trend continues, it would suggest that the Keiretsu system is becoming less of an advantage for Japanese banks. But we should not over generalize about this new trend on the basis of events limited to the spring and summer of 1990. See the attached article for additional background material on this issue.

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City and long-term credit banks

Operating losses

FY89 results of major Japanese banks were a disaster. Although their financial difficulties were partially masked by the newly introduced measure of bank profitability 'business profits', adjusting their results for bond and loan losses shows that only five banks did not have an operating loss last fiscal year. We believe that a quick turnaround in their fortunes is unlikely as interest rates in Japan will remain structurally high in FY90 and the stock market will no longer be a ready source of cash and profits. Given their high valuations, major banks' shares offer investors little upside potential and considerable downside risk. Even the lack of supply that has supported banks' share prices could crumble should the banks' financial position worsen or the banks alienate their stable shareholders by resuming their frantic pace of new equity issues after July

Sell ▶	**IBJ** (8302)
Sell ▶	**Daiichi Kangyo Bank** (8311)
Sell ▶	**Mitsui Taiyo Kobe Bank** (8314)
Sell ▶	**Mitsubishi Bank** (8315)
Sell ▶	**Fuji Bank** (8316)
Sell ▶	**Sumitomo Bank** (8318)
Sell ▶	**Sanwa Bank** (8320)

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Industry
Review

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Japan

The new accounting standard

Japanese banks introduced a new accounting standard in FY89 The stated reason for the change was to improve disclosure particularly in terms of gains and losses from sales of equities and Tokkin funds A new measure of profitability called business profits (*gyomu juneki*) was also introduced to replace the old standard of operating profits (defined as recurring profits less net gains from sales of securities) The banks' income statements under the old and current accounting standard are compared in Fig 1

The accounting changes

1 Sundry interest income was split into interest on deposits, interest on interest rate swaps, sundry interest income and Tokkin profits

2 Gains on interest rate futures transactions (included in sundry income) and premiums from interest rate options transactions (included in fee and commission income) was moved to sundry interest income

3 Fees and commissions (excluding option premiums) was split into foreign exchange commissions and sundry income Compensation for business agreements (included in sundry income) was moved to sundry income

4 Currency option premiums (included in fees and commissions) and currency futures profits (included in sundry income) were moved to foreign exchange transaction gains

5 Gains on sales of securities was split into gains on sales of bonds and gains on sales of equities Gains on redemption of securities was renamed gains on redemptions of bonds Premium income from options trading and profits from futures trading (both formerly included in fees and commissions) were split among gains on sales of bonds, gains on sales of equities, and gains on trading account securities depending on the type of transaction

6 Sundry income was split into sundry income and other revenues

7 Similar changes to items (1) to (6) were made for the expense portion of the income statement

8 Administrative taxes (previously part of SG&A) was made a separate line entry

9 Devaluation of securities was split into valuation loss on equities and valuation loss on bonds

10 Interest income and interest expense arising from interest rate swaps were previously categorized as sundry interest income and expense Now, only the net interest income or expense for each transaction is reported in the sundry interest income or expense categories

11 Included in sundry expenses was the loss from the swap of Mexican debt in FY89

3 ◄

Fig. 1: The banks' old and new accounting statements

Old income statement

- Interest on loans and discounts
- Interest and dividends on securities
- Other interest income
    - Interest on call loans
    - Interest on bills bought
    - Sundry interest income
- Other income
    - Fees and commissions
    - Foreign exchange transaction gains
    - Gains on trading account securities
    - Gains on sales of securities
    - Gains on redemption of securities
    - Sundry income

- Operating expenses
- Interest on deposits
- Interest on debentures
- Amortization of discount on debentures
- Other interest expenses
    - Interest on negotiable CDs
    - Interest on call money
    - Interest on bills sold
    - Interest on borrowings
    - Interest on convertible bonds
    - Sundry interest expenses
- General and administrative expenses
- Other expenses
    - Fees and commissions
    - Foreign exchange transaction losses
    - Losses on trading account securities
    - Transfer to reserve for loan losses
    - Write-off of loans
    - Losses on sales of securities
    - Loss on redemption of securities
    - Devaluation of securities
    - Amortization of dependure expenses
    - Sundry expenses

Recurring profits

New income statement

- Asset management revenues
    - Interest on loans and discounts
    - Interest and dividends on securities
    - Interest on call loans
    - Interest on bills bought
    - Interest on deposits
    - Interest on interest rate swaps
    - Sundry interest income
- Service transactions
    - Foreign exchange commissions
    - Other service revenues
- Other business revenues
    - Foreign exchange transaction gains
    - Gains on trading account securities
    - Gains on sales of bonds
    - Gains on redemption of bonds
    - Sundry income
- Other revenues
    - Gains on sales of equities
    - Tokkin profits
    - Other revenues
- Asset management expenses
    - Interest on deposits
    - Interest on negotiable CDs
    - Interest on call money
    - Interest on bills sold
    - Interest on borrowings
    - Interest on convertible bonds
    - Interest on interest rate swaps
    - Sundry interest expenses
- Service transactions
    - Foreign exchange commissions
    - Other service expenses
- Other business expenses
    - Losses on trading account securities
    - Losses on sales of bonds
    - Loss on redemption of bonds
    - Sundry expenses
- Other expenses
    - Transfer to reserve for loan losses
    - Write-off of loans
    - Loss on sale of equities
    - Valuation loss on equities
    - Loss on Tokkin funds
    - Administrative taxes
    - Other expenses

Recurring profits

Business profits: a new standard of profitability

Business profits is defined as the total of asset management revenues, service revenues, and other business revenues minus the total of asset management expenses, service expenses, other business expenses, most SG&A expenses, and the funding cost of Tokkin assets. Business profits give a better picture of the profitability of a bank compared to operating profits because it includes capital gains or losses on bonds. When operating profits were the standard, Japanese banks would purchase high coupon bonds at prices above par to earn high current income (included in OP) while booking any losses on redemption or sale of the bonds after OP. Business profits also exludes gains from Tokkin funds, which were previously treated as other interest income.

The new standard is not without its faults however. BP excludes loan losses and loss reserves, treating them essentially as extraordinary items rather than as a normal part of banking. This gives banks an incentive to make risky loans to boost returns, since any losses suffered will not affect their reported BP. The new standard also caused many Japanese banks to switch from valuing their bond portfolio at the lower of cost or market to valuing it at acquisition cost in order to avoid reporting any valuation losses on their holdings. This switch also allows them to profit from hedging their portfolios because they can record as income gains on bond futures and options without taking the offsetting valuation losses. And while Tokkin fund income is excluded from business profits, income from investment trusts is included. Finally, it is impossible for an outsider to precisely calculate business profits from published results alone due to a lack of the necessary disclosure.

Fig. 2: Business results of Japanese banks (¥bn)

	FY88 RP	FY89 RP	FY88 BP	FY89 BP	YoY (%)
DKB	387.4	295.4	172.2	170.1	-1
Sumitomo	416.8	352.6	241.3	276.0	14
Fuji	393.6	296.8	171.6	189.6	11
Mitsubishi	355.8	270.9	226.9	162.9	-28
Sanwa	328.3	319.6	160.4	242.9	51
Tokai	141.8	103.6	82.5	11.3	-86
Mitsui TK	288.8	215.6	135.0	132.3	-2
Tokyo	102.3	89.6	79.7	74.0	-7
Kyowa	78.6	62.8	74.6	74.2	1
Daiwa	88.7	61.9	86.3	84.2	-2
Saitama	75.5	50.5	46.7	54.6	17
Hokkaido	44.2	44.8	39.9	34.1	-15
IBJ	195.0	158.6	170.9	92.3	-46
LTCB	128.1	114.8	48.3	56.7	18
NCB	77.1	69.1	21.2	39.6	87
Total	3,102	2,507	1,757	1,695	-3.6

A look at FY89 results

Japanese banks' FY89 results deserve close attention for the simple reason that they were highly misleading. City banks' recurring profits fell 19.9% YoY and their business profits fell only 0.8%. Long-term credit banks' recurring profits fell 14.4% and their business profits fell 21.5%. While these results cannot be called good, they are certainly better than what one would have expected given the sharp rise in both short-term and long-term rates from mid-1989. (See Fig. 2.)

Calculated operating profits

To put their FY89 results in perspective, we calculated the banks' operating profits as defined under the old accounting standard by subtracting net gains on bonds and equities from recurring profits. Although OP is lacking in many respects as a measure of performance, it has the redeeming quality of having been the standard for valuing bank shares for the past two decades. The sharp increase in operating profits seen in FY85-FY87

Fig. 3: Restated operating profits (¥bn)

	FY89 RP	Net bond gains	Net equity gains	FY89 OP	FY88 OP	YoY (%)
DKB	296	-38	296	38	154	-75
Sumitomo	353	-49	244	158	269	-41
Fuji	297	[illegible]	276	54	172	-68
Mitsubishi	271	-4	246	29	138	-81
Sanwa	320	6	218	97	165	-41
Tokai	104	-70	193	-19	97	NM
Mitsui TK	216	-21	214	23	161	-86
Tokyo	90	-6	50	46	81	-43
Kyowa	63	3	26	34	51	-34
Daiwa	62	-14	18	58	68	-16
Saitama	51	9	50	-8	45	NM
Hokkaido	45	-3	56	-8	23	NM
IBJ	159	2	147	10	134	-93
LTCB	115	8	128	20	114	NM
NCB	69	-2	97	-27	32	NM
Total	2,507	(175)	2,217	465	1,731	-73

was one of the primary reasons why investors bid up bank shares so aggressively during this period. The results of this calculation show that on average OP fell 73% YoY in FY89 (Fig. 3), leading us to conclude that the main reason the banks adopted the new accounting standard was to conceal this sharp drop in their profits. As pillars of Japan's nervous financial markets, banks had to maintain the aura of soundness.

Adjusted business profits

The reported business profits of Japanese banks can be adjusted to show more clearly how the banks did in FY89 on an operating basis. Two changes are necessary. The first is to write their bond portfolios to the lower of cost or market. Because of the introduction of the new business profit standard, a number of banks switched to valuing

Fig. 4: Adjusted business profits

(¥bn)

	FY89 BP	Bond valuation losses	Net total	Loss reserves	Loan losses	Adjusted FY89 BP	Mexican write-offs
DKB	170	-192	-22	33	5	-61	75
Sumitomo	276	0	276	29	3	244	71
Fuji	190	-39	151	24	3	123	45
Mitsubishi	163	-81	82	29	4	49	58
Sanwa	243	-59	184	28	6	151	54
Tokai	11	0	11	21	2	-12	60
Mitsui TK	132	-202	-70	32	6	-108	69
Tokyo	74	-81	-7	4	3	-14	83
Kyowa	74	-81	-7	4	1	-12	19
Daiwa	84	0	84	1	1	82	18
Saitama	55	-75	-20	8	2	-31	18
Hokkaido	34	-54	-20	11	1	-32	20
IBJ	92	-220	-128	22	9	-158	51
LTCB	57	-90	-33	26	4	-63	33
NCB	40	-100	-60	9	1	-70	25
Total	1,695	(1,275)	420	281	51	89	698

	FY88 BP	Bond valuation losses	Net total	Loss reserves	Loan losses	Adjusted FY88 BP
DKB	172	0	172	23	1	148
Sumitomo	241	0	241	19	3	219
Fuji	172	0	172	25	2	145
Mitsubishi	227	0	227	22	1	204
Sanwa	160	0	160	21	1	138
Tokai	84	0	84	25	1	58
Mitsui TK	135	-14	121	26	3	91
Tokyo	80	-10	70	5	0	64
Kyowa	75	-4	71	8	0	62
Daiwa	86	0	86	14	1	72
Saitama	47	-3	44	9	0	34
Hokkaido	40	-3	37	9	1	27
IBJ	171	0	171	19	6	146
LTCB	48	0	48	22	1	26
NCB	21	0	21	10	1	10
Total	1,759	(34)	1,725	258	22	1,445

their bond holdings at cost, inflating their earnings compared to those banks (Sumitomo, Tokai, and Daiwa) that valued their bond portfolios at market. Fuji Bank reported that this change in FY89 resulted in a ¥62.7 billion increase in its RP. Sanwa Bank a ¥81.6 billion increase, and Taiyo Kobe a ¥91.4 billion increase. Including valuation losses in bonds also ensures that profits from bond futures hedging is offset by valuation losses.

The second change is to charge to business profits loan writeoffs and loan loss reserves. We have not charged off the losses resulting from the Mexican debt swap in FY89, since this was a one-time occurance, though it could be included for the sake of rigorousness.

The resulting adjusted business profits for FY88 and FY89 are shown in Fig. 4 on page 5. While all banks were profitable under this standard in FY88, only five banks were ~~profitable in FY89. Of these,~~ only Sumitomo, Sanwa, and Daiwa Bank (all Osaka based) saw a YoY increase in adjusted business profits. IBJ suffered the biggest loss of ¥158 billion, followed by Mitsui Taiyo Kobe Bank at ¥108 billion. The collapse in profits at Mitsui and ~~Taiyo Kobe~~ Banks was probably why these two banks had to be merged. MoF has allowed no bank in Japan to go bankrupt since the end of World War II.

The stock market and banks' earnings

The fact that the city banks and long-term credit banks realized net gains from sales of equities of ¥2,217 billion in FY89 while reporting recurring profits of ¥2,507 billion should indicate the importance of the stock market to the banking industry. Without a strong stock market behind them, Japanese banks would be considerably weaker and riskier institutions. And unfortunately for investors, this is exactly the situation the banks now face. No longer will they be able to steadily cash in hidden assets to hide operating problems, to earn high returns from Tokkin funds, and to see their BIS equity ratios increase with each upward move in TOPIX.

The banks' equity hidden assets declined by ¥7.0 trillion or 18% YoY in FY89 due to the crash of the market and the continued realization of their gains (Fig. 5). The market value of their holdings only fell 5% YoY because TOPIX itself was down only 9% in FY89 and the banks continued to be net buyers of shares. Their hidden assets declined by a much greater amount because (1) any change in market value solely affects hidden asset values since book values remain fixed, and (2) the banks realized net gains on hidden assets of ¥2,217 billion.

Fig. 5: Equity holdings of Japanese banks

(¥bn)

	Book value		Hidden assets		Market value		Market/book	
	March 89	March 90	March 89	March 90	March 89	March 90	March 89	March 90
DKB	1,627	2,172	4,357	3,346	5,984	5,518	3.7	2.5
Sumitomo	1,368	1,882	3,487	2,903	4,854	4,785	3.5	2.5
Fuji	1,682	2,085	3,847	3,107	5,529	5,192	3.3	2.5
Mitsubishi	1,326	1,796	4,064	3,382	5,390	5,178	4.1	2.9
Sanwa	1,623	1,949	3,573	3,099	5,196	5,048	3.2	2.6
Tokai	1,031	1,379	2,717	2,485	3,748	3,864	3.6	2.8
Mitsui TK	1,925	2,245	5,072	4,194	6,997	6,439	3.6	2.9
Tokyo	1,069	1,484	1,661	1,145	2,730	2,629	2.6	1.8
Kyowa	439	493	1,737	1,514	2,176	2,006	5.0	4.1
Daiwa	632	748	1,637	1,642	2,269	2,390	3.6	3.2
Saitama	455	579	1,023	848	1,478	1,427	3.2	2.5
Hokkaido	314	405	881	711	1,195	1,116	3.8	2.8
IBJ	1,439	2,075	5,148	4,120	6,587	6,195	4.6	3.0
LTCB	1,096	1,495	3,780	2,990	4,875	4,485	4.4	3.0
NCB	719	946	1,935	1,520	2,654	2,466	3.7	2.6
Total	16,743	21,734	44,920	37,005	61,664	58,739		

Fig. 6: Tokkin assets and returns in FY89

	March 89 (¥bn)	March 90 (¥bn)	Return (¥bn)	ROI (%)
DKB	201	335	0.1	0.0
Sumitomo	186	78	14.4	10.9
Fuji	239	108	-3.6	-2.1
Mitsubishi	156	210	-5.3	-2.9
Sanwa	144	310	7.2	3.2
Tokai	306	290	15.3	5.1
Mitsui TK	300	533	1.8	0.4
Tokyo	269	441	17.5	4.9
Kyowa	88	83	-2.4	-2.8
Daiwa	74	98	-1.6	-1.9
Saitama	202	193	-8.7	-4.4
Hokkaido	97	103	1.6	1.6
IBJ	552	420	40.4	8.3
LTCB	324	324	21.9	6.8
NCB	359	361	0.8	0.2

Fig. 7: BIS equity ratios (%)

	Interim method		Final method	
	March 89	March 90	March 89	March 90
DKB	8.2	8.3	10.1	8.3
Sumitomo	9.2	8.4	8.3	8.4
Fuji	9.9	8.3	8.3	8.3
Mitsubishi	10.3	8.5	8.4	8.4
Sanwa	9.4	8.5	7.8	8.5
Tokai	10.1	8.7	7.7	7.8
Mitsui TK	9.9	8.2	7.4	7.0
Tokyo	8.0	8.0	9.5	8.0
Kyowa	10.5	10.8	7.9	8.6
Daiwa	11.5	10.1	8.6	8.4
Saitama	9.8	8.3	8.4	8.3
Hokkaido	9.6	8.4	7.2	8.3
IBJ	12.0	9.6	9.0	7.8
LTCB	9.5	9.9	7.1	8.2
NCB	9.6	8.8	7.2	7.3

Note: interim must exceed 8% by March 1990, final by March 1993

The book value of their equity investments meanwhile rose sharply, particularly for Sumitomo Bank, Mitsubishi Bank, Bank of Tokyo, IBJ and LTCB, since banks normally repurchase those shares they sell as well as buy a large proportion of corporations' new equity issues. Fewer hidden assets and a declining ratio of market to book value means that banks will be less able to realize gains and will be increasingly vulnerable to a drop in the stock market.

The returns on Tokkin funds also took a plunge in FY89. The banks had ¥3.9 trillion invested in Tokkin funds as of March 1990. Tokkin fund profits were generally poor (Fig. 6), though Sumitomo Bank, IBJ and LTCB somehow managed decent returns on investment. We consider these latter returns suspect, though further analysis is impossible because of poor disclosure. Those banks with the worst adjusted business profits tended to have the largest Tokkin funds. IBJ had ¥552 billion in Tokkin funds, Tokai Bank had ¥306 billion and Mitsui Taiyo Kobe Bank had ¥300 billion. The large size of these holdings indicates that their underlying banking business continues to be poor.

Falling BIS equity ratios

The collapse of the stock market did not greatly affect the banks' BIS equity ratios because many banks had more hidden assets than could be counted as BIS equity capital under the rules. (The contribution from 45% of the value of hidden assets can not exceed the contribution from shareholders' equity.) However, the decline in their "excess" hidden assets will affect the banks BIS equity ratios in the future. Until now whenever a bank had an equity financing or retained earnings, it had been able to count a similar amount of hidden assets. Thus, the ¥5.47 trillion raised through the stock market in 1987-1989 by the city banks (equivalent to 40% of their shareholders' equity) allowed them to count a similar proportion of hidden assets towards their BIS equity ratios. (See Fig. 7)

The effect future movements in the stock market will have on the banks' BIS equity ratios can be seen in figure 8 where we have calculated their BIS equity ratios for various levels of TOPIX. The table shows that regardless of the level of the stock market, IBJ, Nippon Credit Bank, Mitsui Taiyo Kobe and Tokai Bank need to have another financing to raise their level of shareholders' equity to the 8% minimum. The banks which do best under the worst possible scenario for the stock market are Kyowa Bank, Daiwa Bank, IBJ and LTCB, all of which have substantial excess hidden assets. (See Fig. 8 on page 8.)

Fig. 8: BIS equity ratios for various levels of TOPIX

	1,400	1,600	1,800	2,000	2,200	March 90 2,227	2,400	2,600
DKB	5.9	6.5	7.1	7.7	8.2	8.30	8.8	8.9
Sumitomo	6.4	6.9	7.4	7.9	8.4	8.44	8.9	9.4
Fuji	6.0	6.5	7.1	7.6	8.2	8.25	8.7	9.2
Mitsubishi	6.1	6.6	7.2	7.8	8.3	8.40	8.6	8.6
Sanwa	6.2	6.7	7.3	7.9	8.4	8.50	9.0	9.3
Tokai	5.8	6.4	7.1	7.7	7.8	7.80	7.8	7.8
Mitsui TK	5.4	6.0	6.7	7.0	7.0	7.03	7.0	7.0
Tokyo	5.3	5.9	6.6	7.3	7.9	8.00	8.6	9.2
Kyowa	7.6	8.4	8.8	8.8	8.8	8.80	8.8	8.8
Daiwa	6.9	7.7	8.4	8.4	8.4	8.40	8.4	8.4
Saitama	5.9	6.5	7.1	7.6	8.2	8.30	8.8	9.0
Hokkaido	5.9	6.5	7.1	7.6	8.2	8.30	8.3	8.3
IBJ	6.5	7.4	7.8	7.8	7.8	7.80	7.8	7.8
LTCB	6.6	7.4	8.2	8.2	8.2	8.20	8.2	8.2
NCB	5.8	6.6	7.3	7.3	7.3	7.30	7.3	7.3

Valuing bank shares

Given the low quality of earnings of most of the major banks, we believe that valuing them on a multiple of reported net income is not meaningful. A better approach would be to apply an earnings multiplier to their adjusted business profits after tax. For Sumitomo Bank, this amounted to ¥122 billion in FY89, or ¥43 per share. A PER of 20, similar to that of other big companies on the TSE such as Hitachi, Toyota and MEI, would imply a share price of ¥862—only a third of its current share price. For Sanwa Bank, this approach yields a share price of ¥522. However, since most other banks did not even earn a profit at the operating level, this approach is not universally applicable.

An alternative method is to value the banks' shares at their net worth, a reasonable standard given that banks are basically a collection of leveraged financial assets. It is probably unnecessary to pay a premium for the value-added by management given the low returns that Japanese banks have historically generated. If anything, their shares should probably sell at a discount to their net worth, just as the nonlife insurers do.

In Fig. 9 is shown our estimates of the net financial worth of the banks (land holdings are not included). From hidden assets in equities we have added unrealized gains (or losses) in bonds and subtracted off unreserved LDC loans. We then take the after-tax value of this amount to account for deferred capital gains taxes and add it to shareholders' equity. This analysis shows that the net worth (and hence appropriate share price) of Japanese banks is anywhere between ¥550 to ¥1,300 per share.

Earnings outlook for FY90

Japanese banks released rather optimistic forecasts for their business and recurring profits in FY90. However, both these numbers are rather meaningless to investors since they can easily be manipulated. Based on the adjusted business profit standard we developed, it is possible that their profits will recover somewhat since bond losses in FY90 are likely to be less than in FY89. Nevertheless, the sharp increase in short-term and long-term interest rates seen in the latter half of FY89 will continue to squeeze their spreads in FY90 as deposits are rolled over into higher-yielding instruments. Moreover, JF believes that interest rates are heading up in FY90, making any positive earnings surprise unlikely. And even if rates were to suddenly shift direction, the high valuations accorded bank shares would imply such an event has already been discounted in the price.

In addition, the banks will have less room to improve their profitability than in previous years. Over the past decade, Japanese banks were able to raise their lending rates by shifting their lending from large corporations to small businesses, from short-term loans to long-term

Fig. 9. Valuing Japanese banks

	Share holders' equity (¥bn)	Equity hidden assets (¥bn)	Bond hidden assets (¥bn)	LDC debt (¥bn)	Total after tax (¥bn)	FY89 BPS (¥n)	FY88 BPS (¥n)
DKB	1,750	3,346	152	196	3,228	1,107	1,196
Sumitomo	1,937	2,903	15	226	3,283	1,160	1,040
Fuji	1,753	3,107	(39)	191	3,191	1,158	1,193
Mitsubishi	1,601	3,382	(41)	195	3,154	1,152	1,189
Sanwa	1,668	3,099	(59)	196	3,090	1,068	1,034
Tokai	964	2,485	11	167	2,128	1,061	1,032
Mitsui TK	1,489	4,194	(202)	199	1,386	923	1,023
Tokyo	775	1,145	(81)	430	1,092	547	603
Kyowa	473	1,514	(81)	47	1,165	937	1,005
Daiwa	523	1,642	13	48	1,326	936	879
Saitama	451	848	(75)	61	808	799	850
Hokkaido	420	711	(54)	64	616	663	729
IBJ	1,205	4,120	(220)	143	3,083	1,331	1,554
LTCB	969	2,990	(40)	189	2,325	9,731	11,890
Nippon Saiken	457	1,520	(130)	125	1,104	6,382	[illegible]

Fig. 10: FY90 forecast

		BP (¥bn)	RP (¥bn)	NI (¥bn)	EPS (¥n)	PER (x)	P/NAV (x)	Share price (¥n)
IBJ	(8302)	80	140	70	29.8	141	1.2	4,210
LTCB	(8303)	45	100	55	231.1	85	2.0	19,700
NCB	(8304)	35	65	62	185.0	90	2.8	16,600
DKB	(8311)	140	270	140	44.9	52	[illegible]	[illegible]
Hokkaido	(8312)	30	45	20	21.9	55	1.9	1,180
Tokyo	(8313)	110	100	50	25.1	58	[illegible]	1,460
Mitsui TK	(8314)	120	220	110	33.2	68	2.2	2,270
Mitsubishi	(8315)	140	230	115	40.0	62	2.3	2,480
Fuji	(8316)	160	270	140	48.4	56	2.4	[illegible]
Sumitomo	(8318)	230	310	155	49.4	52	2.5	2,570
Daiwa	(8319)	74	74	35	24.7	61	1.6	1,510
Sanwa	(8320)	190	280	140	48.4	47	2.1	2,280
Tokai	(8321)	80	110	60	29.6	60	1.7	1,770
Kyowa	(8322)	60	60	30	23.0	52	1.3	1,200
Saitama	(8330)	47	47	23	22.7	60	1.7	1,370

loans, and from manufacturers to real estate speculators. Today, with 70% of the city banks' loans going to small businesses and half their lending long term, there is little scope for improvement. Real estate lending is no longer a viable alternative as BoJ is cracking down on real estate price inflation.

Risk and return in bank shares

Given the poor financial performance of major banks, it is a wonder that the banks have been able to maintain their high share price valuations for so long and sell so much new equity in recent years. Part of the answer to this can be traced to the fact that the banks' shareholders are largely their corporate clients and/or companies whose shares the banks own. The banks' shareholders hold their shares for strategic, rather than pure investment purposes and thus are not that concerned about the share price. Since so much of the banks' shares are tied up in stable shareholding and thus unavailable for trading, the banks' shares tend to be illiquid. This results in higher valuations than fundamentals would dictate provided there is at least some investor demand.

As a consequence, the banks' poor operating performance may not be reflected in their share prices as sellers may not materialize. Yet, because the banks' share prices are so greatly inflated relative to what fundamental valuations would dictate, their is considerable risk should panic arise about the banks. Higher interest rates, a weakening of the yen or problems in the real estate market could prompt selling. Yet, because of the illiquidity of their shares and the level of their share prices, the decline could be far and fast. Little fundamental buying support is likely to materialize until prices have fallen by at least half.

An additional concern is that banks are likely to be tempted to resume their equity financings once the new issue market reopens in July. Since there is a general reluctance by insurers and corporations to buy more bank shares (or new shares from any issuer for that matter), such a decision by the banks could potentially cause their long-term shareholders to dump their positions in disgust. Life insurers have already publically warned the banks that they are no longer willing to continue subsidizing them by buying their low-yielding script.

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20 August 1990

Mr DW Riegle Jr
Chairman
United States Senate
Committee on Banking, Housing and
Urban Affairs
Washington DC 205 10-6075

Dear Mr Chairman

Following my appearance before the Senate Committee on banking, Housing and Urban Affairs in June, you set out, in your letter of 28 June, some additional questions which you asked me to address. I have attempted to do so in the answers which follow.

Q.1 During our June 13 hearing, Mr Toru Kusukawa, the Deputy President of the Fuji Bank, told us the international competitiveness of banks is largely influenced by the overall economic performance of its home country.

Do you agree with his assessment and if so how much can we increase the competitiveness of American financial institutions through product or geographic expansion or better supervision if we do not deal with the larger macro-economic factors hindering the overall performance of our economy?

A.1 As I said in my prepared remarks, I believe that a strong home country base is of critical importance for the sound and effective functioning of major international banks. It follows, I think, that if a bank's domestic business performs indifferently or badly because of the poor record of its home country economy this will be likely to weaken its overall performance and thus its international competitiveness. It is difficult to be too categoric however. Major UK banks, for example, have been able over the years to maintain strong competitive positions internationally, despite periods when the UK economy has not been performing particularly well. Also among the major international banks outside the US, large parts of their balance sheets will be denominated in currencies other than their own domestic currency: this provides some insulation from the effects of unsuccessful macro-economic management in the home country which may be less readily available to US banks. I would generally agree nonetheless that the macro-economic problems of the US are one of the important background reasons affecting US banks' international profile and performance. I

Offices in Aberdeen Birmingham Bristol Cardiff Edinburgh Glasgow Leeds [illegible] London Manchester Middlesbrough Newport Nottingham [illegible] and Windsor
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The firm is authorised by the Institute of Chartered Accountants in England and Wales to carry on investment business

would argue however that US banks are at least as much affected because of their inability to achieve geographic and product diversification of risks to the same extent as in most other countries, deriving from the present structure of the US banking system.

As a generalisation, losses or deterioration of asset values in banks' balance sheets may derive from the macro-economic environment in the home country (or more widely), but they can also result from management or regulatory inadequacies. These factors are not always easy to disentangle. No doubt US banks' international competitiveness would be assisted by a better balance for example in the budget and the balance of payments in the US but better diversification of risk possibilities and sustaining a strong regulatory oversight are equally if not more critical factors.

Q.2 Mr Hale states on page 7 of his prepared testimony that most English speaking countries liberalized the regulation of financial institutions and markets during the 1980's. He further implies that the resultant competition for business went to reckless extremes in the United States not because of financial liberalization but rather because deregulation "was not accompanied by the development of effective bank supervision."

Would you give us your views on that observation and if you agree with Mr Hale tell us what steps we should take to strengthen our bank supervisory system?

A.2 I think it is important to be clear what we are talking about when we refer to "liberalising regulation". Most financial deregulation around the world in the 1980's I would characterise as institutional deregulation - broadening the powers (or as we say in Europe the permitted activities) of financial institutions. The process was generally far from a reckless dismantling of the regulatory apparatus by the authorities. Indeed in a number of countries, particularly in the UK, it was often accompanied by a tightening of the regulatory arrangements in the areas of conduct of business rules and investor and depositor protection.

Any deregulation, however, needs to be introduced in a way that does not put at risk the financial system as a whole. It is true to say that in a number of countries' national markets, and in the international market-place, greater liberalisation led to more players, increased competition and an erosion of traditional risk/reward relationships and pressures on profits which led to riskier business being undertaken. This scenario has been one of concern to all major countries' regulators, and was extensively discussed in international fora through the 1980's. The general conclusion, I believe, was that the risks which arose did not negate the validity of the liberalisation process, but that it was an important corollary of liberalisation that it needed to be accompanied by close supervisory monitoring. In the US this has, on the whole, been satisfactorily handled by the authorities responsible for banking supervision, within their legislative constraints; it is less clear that the monitoring was effective in the thrift industry.

As to the US supervisory system in general, I believe the professional skills of the banking regulators stand up well to comparison with those in other major countries. The wide spread of regulatory responsibilities, the limits on risk diversification imposed by legislation and exogenous macro-economic factors have been more responsible for the problems than the quality of the supervisors per se. I would also have some reservations about the value of a system with a very high degree of detailed regulatory provisions and requirements which may mean that, on occasion, the wood cannot be seen for the trees; but I believe the banking regulators in many countries have in recent years been alive to this risk and have been adapting their procedures accordingly.

Q.3 When Mr Gerald Corrigan appeared before this Committee on May 3, he urged that we move toward a system of consolidated supervision of any company that has direct or indirect access to the Federal "safety net".

What is the practice in your country on consolidated versus functional regulation? Do you agree with Mr Corrigan on the need for a consolidated supervisor?

A.3 The questions raised by Mr Corrigan's comments are very complex.

It does seem to me that the current trend, worldwide, is for financial service businesses to become more complex and multi-disciplinary, embracing a range of activities for which different supervisors may have responsibility. In the United Kingdom, faced with this phenomenon, the tendency has been to pursue regulation on a functional rather than an institutional basis - an approach whereby the regulators supervise each activity appropriately rather than have one regulator responsible for a category of institution no matter how wide the range of financial service activities it conducts. This approach has of course its difficulties and gives rise to the range of questions about supervisory overlap, potential contagion of risk and the effectiveness of firewalls which are being debated in the United States. In my view this trend toward financial conglomeracy requires that somewhere in the supervisory system someone should be taking a look at the business overall, and this I would equate with Mr Corrigan's comment about the need for a consolidated supervisor. But to have a consolidated supervisor does not necessarily involve a formal accounting consolidation of different companies undertaking different kinds of business within a single group. It calls rather for one body who is known to be maintaining a general oversight of all the business. This concept of course has a particular significance in the context of the Central Banks' lender of last resort function (and the coverage of deposit protection arrangements): it seems to me incontrovertible that if there is a likelihood that the federal safety net will be called into play, the agency responsible for that safety net needs to have some monitoring capacity over those businesses whose problems may lead to the safety net's activation.

Q.4 In his prepared testimony before the Banking Committee on June 20, 1990, Mr David Hale, the Chief Economist for Kemper Financial services, states that:

"Japanese banks typically belong to larger industrial groups (Keiretsu), in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than US firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."

Some observers claim the Keiretsu structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

A.4 I am not an expert in the relative debt/equity levels of US and Japanese institutions but it is clear that, over the past few years, Japanese corporations have been singularly successful in raising new equity without significant downward effect on their share price. This

20 August 1990
Mr DW Riegle Jr
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may in part be due to the Keiretsu structure. I suspect it is also due to other underlying factors (which may or may not be interlinked) such as the high level of savings in Japan and the PE ratios at which Japanese financial corporations trade on the Tokyo stock market making new capital raising a much easier and more attractive proposition for them than for North American or European banks in their stock markets. As long as these circumstances persist they will no doubt be a factor contributing to the strength of Japanese banks competitiveness internationally.

Yours sincerely

Peter Cooke

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Helen K. Sinclair
President

August 2, 1990

Senator Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Riegle:

On June 20, 1990, Mr. Jeffrey S. Chisholm, Vice-Chairman, Bank of Montreal, testified before your committee on behalf of the Canadian Bankers' Association.

In a letter dated June 28, 1990, you posed a number of supplementary questions on financial services trends and developments. I am pleased to provide you with our responses in the enclosed document.

We appreciate this opportunity to offer our views on these important issues. Should you require any additional information, please do not hesitate to contact me.

Yours truly,

cc: Ms Lory Breneman

HKS/RG/ab

August 7, 1990

U.S. Senate Banking Committee Follow-up Questions

Q.1. Mr. Hale states on page 7 of his prepared testimony that most English speaking countries liberalized the regulation of financial institutions and markets during the 1980's. He further implies that the resultant competition for business went to reckless extremes in the United States not because of financial liberalization but rather because deregulation "was not accompanied by the development of effective bank supervision".

Would you give us your views on that observation and if you agree with Mr. Hale tell us what steps we should take to strengthen our bank supervisory system?

A.1. We agree with Mr. Hale's statement. In Canada, we have emphasized the necessity of a strong regulatory framework as a basis from which to liberalize and have ensured that modification of our regulatory and supervisory measures comes first. We have maintained depositor protection as our foremost goal and changes to institutional powers have come only when new supervisory systems are firmly in place. The savings and loan crisis in the United States can been seen as an instance where deregulation occurred without a commensurate increase in regulatory supervision. The reduction in capital requirements for S&Ls, the high level of deposit insurance coverage, and the expansion of S&Ls into non-traditional business activities without adequate regulations in place, greatly contributed, in our view, to the present situation.

In 1987, following recommendations made in the Canadian government's white paper on financial sector reform ("New Directions for the Financial Sector"), the Office of the Superintendent of Financial Institutions (OSFI) was created out of the Office of the Inspector General of Banks and the Department of Insurance to regulate and monitor activities of the major financial institutions in Canada. The OSFI was given increased regulatory strength through the power to invoke cease and desist orders, freeze assets and assume the role of the board of directors and management of a troubled financial institution.

The regulatory powers of the Canada Deposit Insurance Corporation (CDIC) were also strengthened. The Chairman of CDIC can now withdraw coverage from a member institution which no longer meets CDIC's standards of sound business and financial practices. In addition, the Chairman has the power to increase premium surcharges to member institutions whose practices do not conform to CDIC by-laws.

With the deposit insurance and supervision systems strengthened, the Canadian government has begun to implement regulatory changes which include enhancement to financial institutions' business powers (e.g., in 1987 banks were permitted to own a full-service securities subsidiary).

There are a number of alternative measures which can be taken to strengthen the U.S. bank supervisory system. The creation of a type of "super-regulator", as embodied in the OSFI here in Canada, is one option which would work to alleviate some of the supervisory fragmentation in the U.S. system. Even with the super-regulator model, we recognize the need for flexibility to deal with the constitutional division of regulatory responsibilities between the federal and sub-national governments. For further explanation of this approach, please see the answer to the second question below.

In addition to increased supervisory mechanisms, regulatory measures could be tightened, as well. An example of increased regulatory stringency that could be introduced in the U.S. system is the dual auditing process required of Canadian banks.

Q.2. When Mr. Gerald Corrigan appeared before this Committee on May 3, he urged that we move toward a system of consolidated supervision of any company that has direct or indirect access to the Federal "safety net".

What is the practice in your country on consolidated versus functional regulation? Do you agree with Mr. Corrigan on the need for a consolidated supervisor?

A.2. We fully support the consolidated supervision model of financial regulation. As stated above, the creation of the OSFI, amalgamating two separate regulatory bodies, effectively consolidated supervision at the federal level. Regulation is based on a functional breakdown, however, through legislation governing financial institutions (the Bank Act, Trust Companies Act, Loan Companies Act, and the Insurance Acts, for example). The OSFI is made up of two operating units (one for insurance and pension funds, and one for deposit-taking institutions) which are responsible for administering these acts.

Due to Canada's constitutional division of regulatory responsibility for financial institutions, some responsibility continues to rest with the provinces. The federal government has exclusive jurisdiction over only the banks, thus most provinces have developed regulations for provincially-incorporated trust and insurance companies (which are mostly small and regional in make-up). The securities industry is regulated at the provincial level, as well. The OSFI has established an ongoing relationship with the provincial securities commissions in drafting policy and sharing information, and this cooperative approach among the different regulatory bodies has been extended into the insurance and trust fields.

As a further means to ensure supervision is consolidated, a super-consultative committee has been formed, consisting of the Bank of Canada Governor, the Deputy Minister of Finance, the Superintendent of Financial Institutions, and the Chairman of the CDIC. In this way, co-ordination of regulation is facilitated, any inadvertent competition between regulatory authorities is avoided, and regulators are kept informed. Because of the overall co-operative nature of regulators in Canada, and their willingness to consult with each other, we feel our current system is the right approach and is as close to "consolidated supervision" as necessary.

Q.3. You state on page 9 of your testimony that although Canada has reduced the barriers to foreign bank activities, such banks have not done well in Canada. You further state that in your view this suggests "that there did not exist high unexploited opportunities in the Canadian market".

Foreign banks in contrast have done very well in the United States. Can you offer your views on why they have done so much better here than they have in Canada.

A.3. Of the 64 banks in Canada, 56 of them are foreign-owned. There has been a great divergence in the financial performance of these foreign banks in Canada. Some have performed very well, such as BT Bank of Canada (a subsidiary of Bankers Trust), Citibank Canada and Hongkong Bank of Canada. The foreign banks in general, however, have had some difficulties because their business is predominantly on the wholesale side (e.g., corporate lending), a market which has experienced weak margins worldwide for an extended period. This is unlike the situation in the U.S. where many of the foreign bank operations are in the retail/commercial sphere. An example of a successful foreign bank operation of which you are familiar, due to Mr. Chisholm's testimony, is the Harris Trust and Savings Bank, a subsidiary of the Bank of Montreal.

Foreign banks in the U.S. are also aided by the fragmentation of the U.S. financial system which hinders full exploitation of the domestic market by domestic banks. The interstate branching restrictions, as well as the prohibition on performing securities activities are examples of outdated regulations which have impaired the competitiveness of U.S. banks, both at home and abroad, thereby increasing the opportunities for foreign banks to compete in the U.S.

Q.4. You briefly discuss the U.S.-Canada Free Trade Agreement on page 8 of your testimony. Under that Agreement, while U.S. banks get more favourable treatment than any other foreign banks in Canada, they do not receive full national treatment. The Europeans under the reciprocal national treatment provision of the Second Banking Directive will be pressing Canada to give European banks full national treatment. If Canada eventually extends such treatment to European Banks will it do the same for U.S. banks in Canada?

A.4. Under the U.S.-Canada Free Trade Agreement (FTA), U.S. banks in Canada do enjoy full national treatment. Chapter 17 of the FTA relieves the U.S. from restrictions affecting foreign banks in Canada. Therefore, U.S. banks in Canada enjoy the same powers, rights, and privileges as domestic banks in Canada. Because our financial structure is more liberalized, the benefits gained by U.S. banks operating in Canada are greater than the benefits provided to Canadian banks operating in the U.S.

The only possible exception to the provision of national treatment is the requirement that foreign banks be established as subsidiaries. As we understand it, this requirement is based on prudential regulatory considerations. Outside of a free trade agreement, if Canada were to exempt the EC from this requirement, we would be obliged under the OECD Codes of Liberalization to provide this exemption to all other OECD members.

Q.5. During our June 13 hearing, Mr. Toru Kasukawa, the Deputy President of the Fuji Bank told us the international competitiveness of banks is largely influenced by the overall economic performance of its home country.

Do you agree with his assessment and if so how much can we increase the competitiveness of American financial institutions through product or geographic expansion or better supervision if we do not deal with the larger macro-economic factors hindering the overall performance of our economy?

A.5. Obviously, a country's macro-economic health is a factor in the international competitiveness of its financial institutions, but there are other important factors. Macro-economic health is reflected, in part, by the cost of capital, which is of considerable importance to the international competitiveness of banks. Both Canada and the U.S. have high capital costs and are disadvantaged in this area vis-a-vis Japan and some European countries.

Finding a solution to the high cost of capital dilemma requires changes to long-term macro-economic policies. In the shorter term, however, there are a variety of alternative means to increase the international competitiveness of banks.

We believe that permitting banks to branch nationwide and to exercise broader business powers (e.g., insurance, securities), under adequate supervisory control, serves to strengthen their international competitiveness. For countries at a cost of capital disadvantage, product diversification, in particular, increases banks' competitiveness by expanding their range of fee-based product offerings and, in doing so, compensates for their lack of competitiveness in traditional lending markets.

Q.6. In his prepared testimony before the Banking Committee on June 20, 1980, Mr. David Hale, the Chief Economist for Kemper Financial Services, states that:

> "Japanese banks typically belong to larger industrial groups (keiretsu) in which they have extensive cross shareholdings. As a result, the functional distinction between bank loans and permanent capital is much weaker than in the United States. These close relationships have permitted Japanese firms to operate with much higher levels of debt than U.S. firms. In the late 1980's, they also allowed Japanese banks to raise large amounts of capital from business affiliates without depressing their share prices."

Some observers claim the keiretsu structure gives Japanese banks a significant competitive advantage in Japan's domestic market and also strengthens their international competitiveness. Do you agree with such an assessment? Please explain why or why not.

A.6. We would agree that the keiretsu system has strengthened Japanese banks in their domestic market. This structure, with a main bank at the center of each keiretsu grouping, virtually ensures the viability of the group's affiliated companies. Although affiliated firms may borrow widely, their main bank relationship is with the bank at the group's core. In the close relationship between the companies and the main bank, loans are rolled over continually, resulting in what amounts to permanent financing. The banks usually continue to supply funds to affiliated companies which may be in difficulty, allowing them to defer interest payments. For companies with ongoing difficulties, the banks often spearhead a restructuring or folding of the companies into another firm, usually from within the same group.

In addition to financial arrangements, institutions within the keiretsu are bound together by informal cooperative relationships. It is customary for the presidents of each of the major affiliated firms to meet regularly to coordinate strategy and discuss common problems. The main banks play a key role in formulating and directing strategic plans for their corporate clients and thus have proprietary access to managerial and technological developments within their affiliated companies. In this manner, the banks also have immediate access to technological developments in areas of use to financial services, such as telecommunications and computer technology. In addition, according to Richard Wright and Gunter Pauli, authors of The Second Wave: Japan's Global Assault on Financial Services, as much as 50% of the total volume of business done by members of the group is with other members of the same keiretsu.

Both the bank and other firms within each group also own shares of the other member firms. Although shareholdings by any one firm are limited to 5%, effective control of each member company is usually held by so-called "stable-shareholders" within the same keiretsu group. This interlocking ownership structure means that all financial transactions with members of the same group remain within the "family".

This close relationship benefits commercial firms and ensures the bank a captive market. With Japanese commercial firms basically captive to their main bank, the market opportunities for foreign banks are kept meager. Thus the system has resulted in indigenous banks being the most viable in the Japanese market.

The keiretsu system has not guaranteed high profits for the Japanese banks, however. Although the six largest banks in the world are Japanese, no Japanese bank ranks among the top ten most profitable (Business Week, July 2, 1990). The system has served nonetheless to insulate the domestic Japanese financial system from competition from abroad.

We believe that success of the keiretsu system rests on cultural factors that cannot be "borrowed" or copied by other countries. Inter-company dealings which tie the keiretsu together would be seen in Canada as competitively restrictive. We do not favour the diminished competition and increased concentration of assets and economic power that would result from these arrangements. Furthermore, it would also be very difficult to impose the disciplines of the Japanese corporate life on North American companies. The kind of consultation and co-operation in Japanese business is not in the tradition of competition ingrained in corporate North America.

From a regulatory perspective, we feel the complex web of interrelationships and cross-holdings inherent in the keiretsu system would hinder regulators' ability to properly supervise activities within the group.

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